

# **USAID/COSTA RICA**

**FY 1992 ESF**

**TRADE AND INVESTMENT II**

**CONCEPT PAPER**

**December 24, 1991**

## TRADE AND INVESTMENT II: CONCEPT PAPER

### TABLE OF CONTENTS

	<u>Page No.</u>
I. SUMMARY AND CONCLUSIONS	1
A. Political Climate	1
B. Economic Performance	2
C. US Government Role	4
II. BACKGROUND	7
A. General Background	7
B. Recent Economic Performance and Outlook	8
1. Output	9
2. Prices	10
3. Public Sector Finances	11
4. Financial Intermediation	16
5. Balance of Payments	18
6. International Reserves	19
7. Exchange Rate Developments	20
8. External Debt	23
C. The 1991 IMF Agreement	23
D. Progress under SAL II and Plans for SAL III	27
III. EVALUATION OF PERFORMANCE UNDER THE TRADE AND INVESTMENT PROGRAM I (1991 ESF PROGRAM)	30
IV. MAJOR ECONOMIC ISSUES	33
A. Macroeconomic Stability	33
B. Exchange Rate Regime	33
C. Trade Liberalization	34
D. Financial Sector	35
E. Public Sector Efficiency	36
V. PROGRAM RATIONALE	38

	<u>Page No.</u>
VI. THE PROPOSED PROGRAM	40
A. Economic Policy Measures	40
B. Timing of Disbursements	42
C. Uses of Dollars and Local Currency	43
1. Dollars	43
2. Local Currency	44
D. Implementation Procedures	45
1. Disbursement Procedures	45
2. Reimbursement Procedures	46
3. Audit Provisions	47
E. Relationship with Mission Strategy	48
F. Complementary Mission Activities	49
G. Other Donor Coordination	49
GRAPHS:	
Graph 1     Annual GDP Growth Rates	9a
Graph 2     Index of Monthly Economic Activity	10a
Graph 3     Unemployment Rate	10b
Graph 4     Inflation	10c
Graph 5     Inflation - General CPI	10d
Graph 6     Inflation - Controlled CPI	10e
Graph 7     Inflation - Non-Controlled CPI	10e
Graph 8     Operations of the Public Sector	11a
Graph 9     Non-financial Public Sector Balance	11a
Graph 10    Central Government: Main Expenditures	15a
Graph 11    Float in Relation to Liabilities	17a
Subject to Requirement "Bicicleta"	

Graph 12	Difference in Relation to Liabilities Subject to Requirement	17a
Graph 13	Banking System: Net Domestic Assets Seasonally Adjusted	17b
Graph 14	Sources of Change in Liquidity	18a
Graph 15	Real Deposit Interest Rate at Private Banks - 6 Months Rate	18b
Graph 16	Central Bank: Net Official Reserves	20c
Graph 17	Central Bank: Liquid Reserves	20a

#### TABLES

Table 1	Operations of the Consolidated Public Sector (Millions of Colones)	11b
Table 2	Operations of the Consolidated Public Sector (Annual % Change)	11c
Table 3	Balance of Payments	18c
Table 4	IMF Stand-By Program	24a

#### POLICY MATRIX

40a

## I. SUMMARY AND CONCLUSIONS

### A. Political Climate

The proposed FY 1992-93 Trade and Investment II (TIP II) program focuses on the most critical years of the Calderon Administration's stewardship of the Costa Rican economy. It builds upon the gains of TIP I, and follows the same strategy of using our significantly reduced ESF levels as a precursor to the more significant resource flows expected from IBRD and IDB. Thus, TIP II sets the stage even in the event other donor resources are delayed.

The pace of reform in Costa Rica continues to reflect the reluctance of the Calderon Administration, and the political and economic establishment in general, to undertake bold initiatives which are not supported by either the general population or the fragmented political opposition. Thus, while the administration has made a public commitment to structural adjustment measures, most of its energies, day-to-day attention and successes have been in the area of fiscal and balance of payments stabilization.

Incrementalism and the seeking of "consensus," which has marked this administration from the beginning, reflect (1) the traditional conservative approach taken by this country on major issues, (2) the resistance by many vested groups to significantly alter the status quo now working in their favor, and (3) the strong democratic and legalistic environment which places legislative barriers to most of the required significant structural adjustment measures.

The pace and extent of reform -- how much, how fast, affecting whom? -- came to a head in November 1991 when President Calderon faced mounting internal opposition to two aspects of his program -- cutbacks on transfers to the universities, whose levels had been agreed upon by the previous administration, and forced lay-offs of public employees. These high-profile issues had been identified as major contributors to a reduction of the public sector deficit, and were seen by some as a litmus test of the administration's resolve to control spending. Acting on advice of his labor, economic and security ministers, President Calderon backed away from confrontation with students and workers (who were marching in the streets) and announced compliance with their demands. The subsequent resignation of the Minister of Finance caused an unexpected firestorm and other changes in the cabinet. At first blush, it appeared significant further reform was in for rough water.

On balance, however, this episode has refocused the modernization debate. One, President Calderon was forced to publicly and forcibly reaffirm his commitment to continued reform. Two, public attention was focused dramatically on the fiscal problem and the consequences of not complying with the IMF agreement, i.e., President Calderon's room for equivocation was significantly reduced. Three, he publicly reaffirmed his commitment, for the first time, to lower tariffs. Fourth, the shift of the Minister of the Presidency to Finance and the appointment of a new and dynamic political pro as Presidency Minister resulted in a significant strengthening of the team at a pragmatic level. As a result relations with Congress and the opposition are expected to improve significantly. Finally, the new Minister of Finance has demonstrated strong commitment to maintain fiscal austerity, and we fully expect the 1991 end-of-year consolidated deficit to be approximately 1.9 percent of GDP, a significant and noteworthy accomplishment.

In sum, while the GOCR remains committed to reform, it has opted for an incremental approach. Our task now is to continue to energize those elements of the administration and other sectors who support the reforms necessary to move beyond stabilization to structural adjustment. Our proposed conditionality agenda is more ambitious than TIP I, in spite of reduced levels, precisely because we believe this PAAD offers the last best chance to leverage ESF resources of any magnitude against GOCR performance in a number of key areas. This recognizes that future year dialogues will require more persuasion of self-interest, and absent any USG/GOCR progress on EAI, more likely a lower USG profile involving traditional diplomatic and trade instruments.

#### B. Economic Performance

When the present administration took office in May 1990, the passive public sector deficit was 7 percent of the GDP, monetary expansion was being fueled by the notorious "bicicleta," the real effective exchange rate had appreciated by about 6 percent and therefore, international competitiveness had been reduced, the deficits of the current and capital accounts of the balance of payments were growing, net international reserves were declining rapidly, and conclusion of the Brady Plan debt buy-back reduced freely disposable international reserves to the equivalent of only about two weeks of imports of goods and non-factor services at the end of May 1990.

Immediately after taking office, the Calderon Administration began to negotiate a Stand-by arrangement with the IMF and a Third Structural Adjustment Loan (SAL III) with the World Bank. The centerpiece of the financial stabilization program was a sharp reduction of the public sector deficit.

Management of the economy has been the over-riding concern of the Calderon Administration during its first 18 months. Notwithstanding several notable achievements, overall economic performance has been mixed. The main aspects have been:

- GDP growth in 1991 is estimated at only one percent, the lowest rate of growth since 1985. The monthly index of economic activity, however, started to accelerate in mid-1991 indicating a recovery for 1992.
- Inflation in 1990 was 27.5 percent, and in 1991 it is estimated that it will be 25 percent, relatively high rates for Costa Rica. Inflation reached its peak in mid-1991 and has been declining steadily, a result of the more restrictive monetary policy which began to be implemented in early 1991.
- The consolidated public sector deficit (including Central Bank losses) in 1990 would have been 7 percent of the GDP if the fiscal adjustment program had not been implemented. The strong adjustment program which began in June 1990 resulted in a lowering of the deficit to 4.7 percent in 1990 and to an estimated deficit of 1.9 percent of the GDP in 1991. The deficit reduction was a result of a very restrictive public sector wage policy, of a temporary increase in the sales tax rate from 10 to 13 percent, and of sharply higher prices and tariffs of state-owned enterprises. While the 1991 deficit is higher than the IMF program target, it is one of the lowest deficits ever achieved in Costa Rica, and it is the result mostly of Central Bank losses (expected to be 1.7 percent of the GDP). See Graphs 8 and 9. For 1992, the authorities are formulating a fiscal adjustment program that would bring the public sector deficit down to one percent of the GDP.
- The improvement in the fiscal situation in early 1991 permitted the implementation of a more restrictive monetary policy since that time. The lag between changes in the money supply and the effect on prices in Costa Rica has been estimated at six to twelve months. Therefore, the effect of the more restrictive monetary policy will not reduce inflation significantly until early 1992.
- The balance of payments situation has improved markedly, the result of an improvement in the current and capital accounts. The improvement of the capital account was due largely to a sharp increase in private capital inflows, a sign of renewed confidence in the economy.
- Net international reserves increased by more than US\$400 million during the first nine months of 1991.

- Requests for foreign exchange at the Central Bank with a delay of more than 15 days (the "presa"). which had exceeded \$100 million in December 1990, have now been reduced to zero.

- During the period May 1990 to June 1991, there has been a devaluation of the real effective exchange rate of about 8 percent. This real devaluation, however, has required a very high nominal devaluation, and there is a danger that unless the fiscal situation improves further, Costa Rica could enter into a devaluation-inflation-devaluation spiral.

- The monetary, net international reserves and arrear reduction targets of the IMF program were met in September 1991, while the central government expenditure and the public sector domestic borrowing targets were not met. It is very likely that the December 1991 performance will be the same. The improvement in the net international reserve position of the Central Bank, the key objective of the program, will be met with an ample margin.

The Mission's assessment is that economic management has been reasonably good even though two of the five IMF targets have not been met. Sebastian Edwards, considered by many one of the best macroeconomists in the world, gave the overall program a B grade -- an average of exchange rate policy (A-), monetary policy (B-) and fiscal policy (C+). Mr. Edwards did not have time, however, to look at the fiscal situation in sufficient detail, but the Mission believes that a grade of C+ is generous.

Future economic stability will depend almost exclusively on the ability of the authorities to implement measures that will result in a fiscal deficit of one percent of the GDP in 1992. Most of the measures being considered to reduce the deficit (teachers pension reform, the reform of the system of "laudos," and the rationalization of the system of exonerations) require legislation, and therefore it is not possible to predict if and when they will be enacted into legislation.

#### C. US Government Role

The GOOCR economic team has concentrated its efforts on the financial stabilization program, principally on fiscal adjustment -- structural adjustment, as such, has been seen as less pressing. It is in raising the priority of reform that the AID Mission has made a very significant contribution through our policy dialogue, an applied economic policy research program, and in conjunction with other elements in the Embassy, through an ambitious public diplomacy program.

Measures to increase the independence of the Central Bank, the public sector workforce reduction program, the physical closing of CODESA (the holding company for many state-owned enterprises), the submission of legislation to rationalize the system of exonerations and of pensions, and the commitment to a reduction of tariff protection were among the most significant structural adjustment measures implemented by the Calderon Administration since it took office. All these measures were part of the FY 1991 Trade and Investment I conditionality package.

The FY 1992 Trade and Investment Program II (TIP II), financed with this PAAD, has been formulated as a two-year program. We have designed a two-year program, because most of the important policy changes that we are proposing cannot be achieved in one year. The TIP II has been designed in close collaboration with the IDB and the World Bank, and will reinforce and accelerate the approval and implementation of policy-based loans from those two institutions. The main objective of the policy measures to be implemented under TIP II is to deepen trade liberalization and therefore position Costa Rica for an early participation in all aspects of the Enterprise for the Americas Initiative (EAI).

The program is concentrated in five areas of policy reform. These are:

1. Macroeconomic Stability. Measures include the adherence to fiscal, monetary and balance of payments targets, as well as measures designed to increase the administrative and financial independence of the Central Bank.

2. Liberalization of the Foreign Exchange Regime. These measures will liberalize the capital account of the balance of payments, legalize contracts denominated in foreign exchange, and clarify the power of the Central Bank to establish the exchange rate.

3. Deepen Trade Liberalization. The core of TIP II is a lowering of the tariff ceiling from 40 to 20 percent, without exceptions, by June 1993. Measures to limit price and margin controls and to increase the protection of intellectual property rights are also included, and these will also contribute to trade liberalization and to full participation in the EAI.

4. Increase the Efficiency of the Financial Sector. Measures to limit Central Bank intervention in the establishment of interest rates and credit limits will be implemented, a study of the taxation of capital markets will be carried out to identify ways to increase the neutrality of the tax system, and a strategy to increase the efficiency of state-owned banks will be formulated.

5. Increase the Efficiency of the Public Sector. The workforce reduction program will be continued; plans to restructure four ministries will be formulated and implemented; the private provision of selected public services will be studied, and measures to accomplish this will be carried out; and measures to permit the private operation of ports will be undertaken.

The program is ambitious and far-reaching. Without USG support through ESF and technical assistance, it is unlikely to succeed. Left to his own inclinations, President Calderon would likely focus on more traditional growth strategies based upon social investment. TIP II offers the vehicle for us to keep structural adjustment issues in the forefront of GOCR thinking.

## II. BACKGROUND

### A. General Background

With its tradition of democracy and social justice, Costa Rica shares and supports the U.S. goal of promoting democracy, development and disarmament in Central America, and continues to play an active and positive role in regional peace efforts. Costa Rica welcomed the Enterprise for the Americas Initiative (EAI), and has taken a leading role in launching the Partnership for Democracy and Development (PDD), wherein 29 countries agreed to create a framework of regional cooperation. In these vitally important areas, Costa Rica provides a model for other countries in the region.

Shortly after taking office in May 1990, the Calderon Administration embraced the goal of positioning Costa Rica in the front ranks of Latin American nations prepared to take advantage of the cooperation and assistance provided by the PDD and the EAI. Having campaigned on a populist platform, the Calderon Administration's political leadership entered office ill-prepared to deal with the rapidly deteriorating fiscal conditions in the country or with the compelling need to undertake fundamental changes in the philosophy and structure of public sector expenditures. However, pushed by the fiscal deficit and pulled by the prospect of EAI benefits, the GOCR came down in favor of pursuing a program of economic reform and trade liberalization.

While some greater direction on economic policy was evident during the first sixteen months of the Calderon Administration, the political price of implementing difficult fiscal and public sector reforms increased. An apparent set-back took place with the resignation of the outspoken Minister of Finance, who was at the forefront of the economic reform program. While our initial assessment of this cabinet change was highly negative, the new Minister of Finance has reaffirmed the commitment of the authorities to continue with the adjustment program supported by AID and the IMF, and he has already initiated discussions with the IMF to extend the present Stand-by Arrangement by six months, i.e., until October 1992. Another positive development has been the announcement by President Calderon in November 1991, of the lowering of the tariff ceiling to 20 percent by the end of 1992, with a few exceptions for sensitive industries. Recently, the possibility of lowering tariffs to 20 percent by June 1993 with no exceptions is being discussed.

The current Administration faces an opposition party that is divided into at least five camps, some of whom support the present efforts but others which are diametrically opposed to the structural adjustment program, and this has significantly

delayed those measures which require action by the legislature. Recently the President of the PLN issued a statement expressing strong opposition to a Third Structural Adjustment Loan (SAL III) from the World Bank. Naming a member of the Legislative Assembly to the position of Minister of the Presidency may improve relations between the executive and legislative branches.

Another challenge to the Administration's reform efforts comes from important elements of the country's private industrial sector, which are waging a strong and well-financed campaign to oppose or at least delay further liberalization of the economy. The issue of tariff reduction is particularly targeted.

In short, economic reform in Costa Rica, as in other pluralistic democracies, will be a contentious and ongoing process in which vested interests use the open political system to deflect or delay changes they perceive as not to their parochial advantage. The GOCR has demonstrated its intent and determination to complete the structural transformation from an import-substitution and public sector-dominated production model to one based on export-led growth and free-market production. Almost halfway through its term, however, the Calderon Administration has only begun the job, and the results cannot be assumed. Careful attention to developments is appropriate and required. AID sees its role as being the early catalyst for those actions necessary to advance this agenda and to promote reforms that would help lead to EAI debt reduction and continued good relations with International Financial Institutions. While resentment of declining USG foreign assistance levels is increasing, the significant reduction in ESF levels has not yet mitigated our ability to play this strong supporting role.

In a speech at an AID financed seminar in July 1991, and in another speech in November 1991, President Calderon reaffirmed his commitment to furthering trade liberalization and to a reduction of the size of the State. Support by the USG of this initiative during the next crucial two years of his Administration will greatly increase the probability of its success.

#### B. Recent Economic Performance and Outlook

The 1991 ESF PAAD (Trade and Investment I) provided economic data spanning several decades. This Concept Paper (Trade and Investment II) generally provides data of economic performance during 1990-91, based on information available as of early November 1991. To place 1991 economic performance in a longer term context, however, some graphs summarizing the most important long-term economic trends are also included in the Concept Paper. They demonstrate that, among other things,

President Calderon's measures to stabilize the economy have reduced the public sector deficit to the lowest level since the crisis of the early 1980s.

### 1. Output

Graph 1 provides growth rates for GDP.

An underlying assumption of the 1991 IMF program was that real GDP growth in 1991 would be 3.5 percent, a target that most analysts considered too optimistic, particularly because of slow world economic growth and the fiscal austerity which was required in 1991. CEFSA, one of the most highly respected consulting firms of Costa Rica, forecasted that GDP would grow by 1.5 percent in 1991. The Central Bank has estimated that the GDP growth rate in 1991 will be around one percent.

In the 12 month period ending September, 1991, there was a decline in cement sales (8.6 percent), in the construction area (3.3 percent) and in the consumption of fuel derivatives (1.9 percent). In the 12 month period ending June 30, 1991, electricity consumption increased by 2.6 percent, compared to an increase of 7.7 percent during the same period in 1989-90.

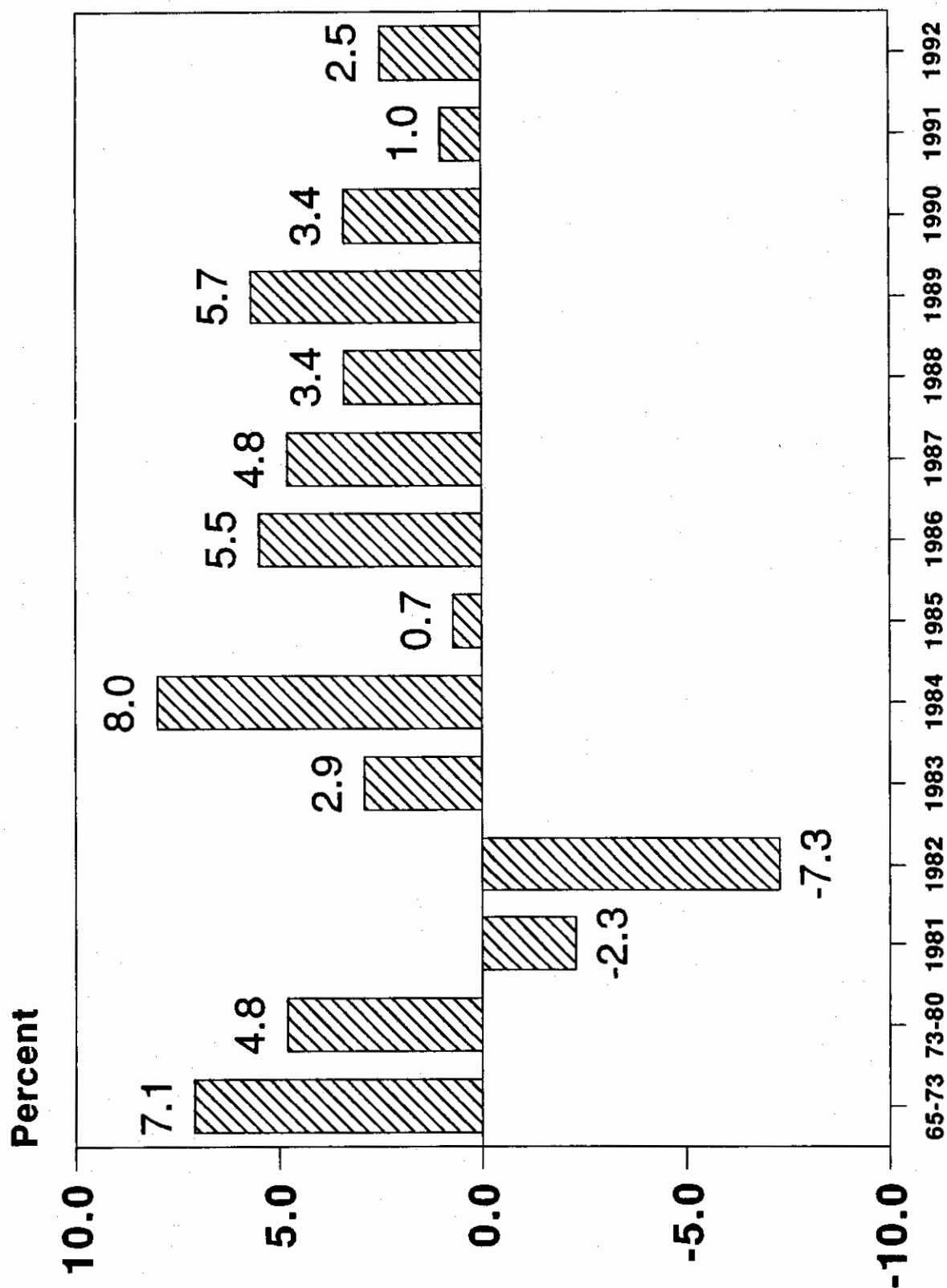
The monthly index of economic activity (Indice Mensual de Actividad Economica, IMAE) prepared by the Central Bank increased by 2.5 percent in the period July 1990 to July 1991. The growth rate of the components of the index for the 12-month period ending July 1991 are (in percent):

Agriculture	8.8
Industry	7.0
Utilities	5.3
Construction	-9.1
Commerce	0.7
Transportation	-4.7
Financial intermediation	-1.5
Real estate	1.6
Government	1.0
Total	2.5

# Annual GDP Growth Rates

- 9a -

GRAPH 1



Based on the IMAE, the Central Bank has estimated GDP growth in 1991 at one percent. An encouraging sign for 1992 is given by the trend of the IMAE. The trend of the IMAE, which is shown in Graph 2 shows that the growth rate began to accelerate in 1991. (Acceleration is defined as the growth rate in one month minus the growth rate of the previous month of the index adjusted for seasonal and random movements.) Based on this, the Central Bank is forecasting GDP growth for 1992 at 2-3.5 percent.

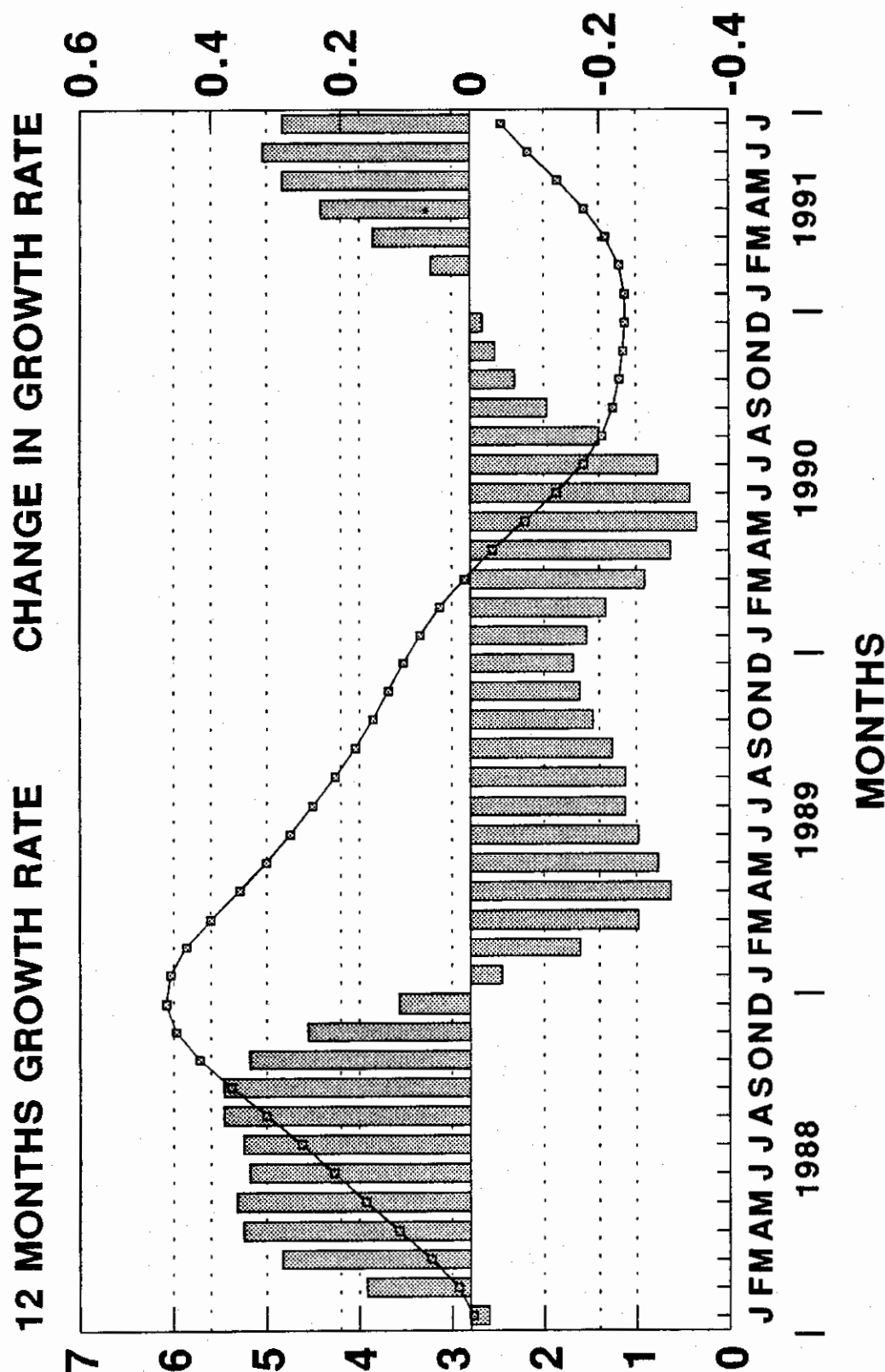
The unemployment rate increased from 4.6 percent in 1991 to 5.5 percent in 1992, largely due to the increase in unemployment in the Central Valley. The unemployment rate decreased in the north, probably the result of rapid export-led growth. In the Atlantic region, a reduction of the participation rate resulted in a reduction of unemployment. A possible explanation of the decline in the participation rate in the Atlantic region is that individuals withdrew from the workforce in order to repair damages to their own houses and other assets, a phenomenon that often occurs after major natural disasters. Historic unemployment rates are given in Graph 3.

## 2. Prices

Historic inflation rates are given in Graph 4. The failure to control inflation has been the most important failure of the economic program. As shown in Graph 5 the inflation rate (measured by the change in the consumer price index (CPI) over the previous 12 months) increased steadily since early 1990 until May 1991, when it started to decline. The decline in inflation of recent months is represented by the bars in Graph 5, where it is shown that inflation for the three-month period ending November 1991 was running at an annual rate of about 18 percent. The sharpest decline has been in the portion of the CPI which is controlled by the government (prices and tariffs of state-owned enterprises and prices of goods in the "canasta basica"). The non-controlled CPI, however, has also declined steadily (Graphs 6 and 7).

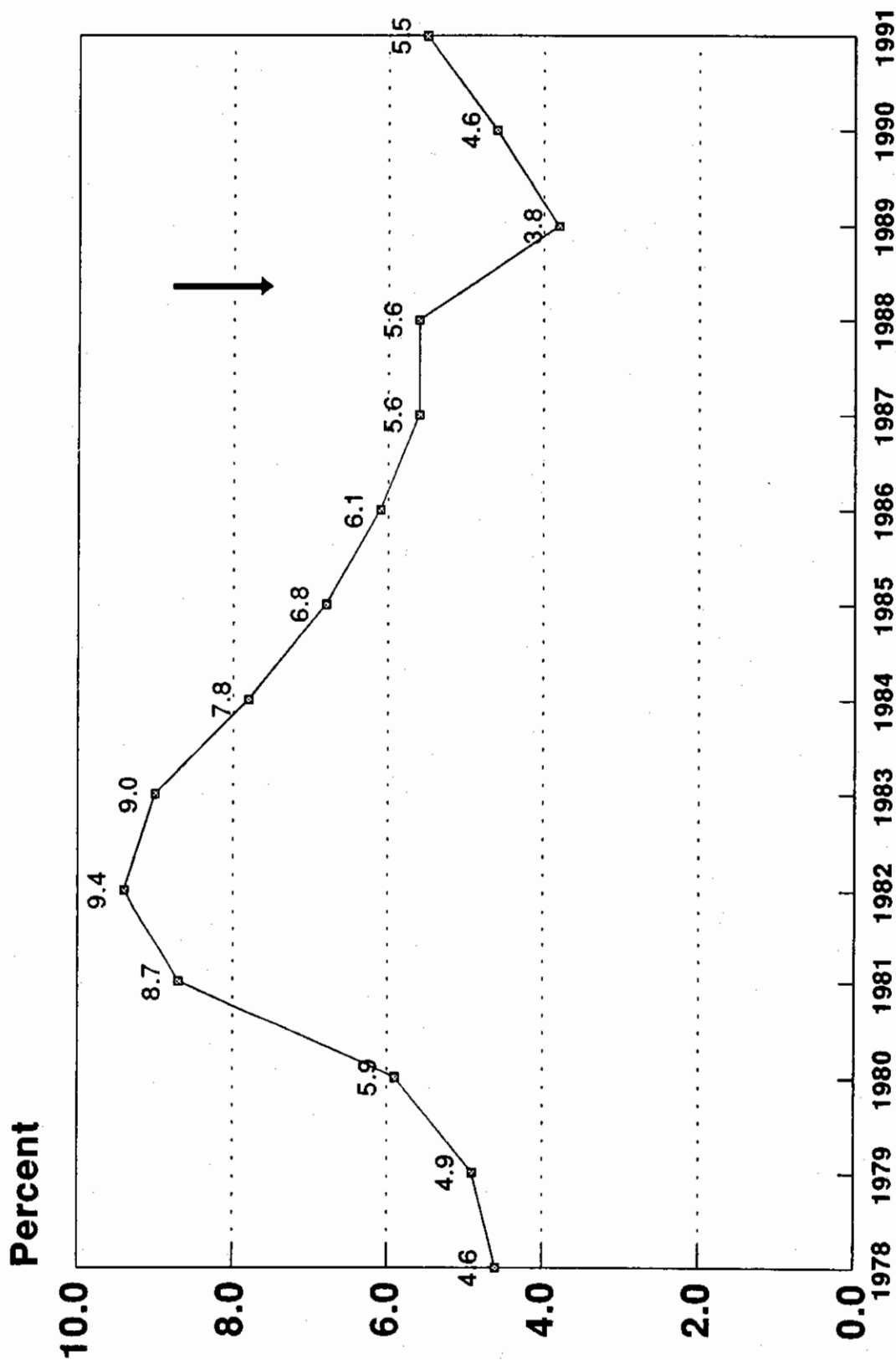
A debate on the causes of inflation is taking place in Costa Rica, and it is often argued that the policy of mini-devaluations is the main source of inflationary pressure. As discussed in the section on Financial Intermediation (II-B-4), inflation can be explained by the rapid rate of growth in the net domestic assets of the banking system in late 1989 and 1990. Those increases in the money supply of domestic origin were the result of increased credit to the public sector, Central Bank losses, and monetization associated with AID supported programs. Accumulation of net official reserves has been the main source of increases in liquidity since the beginning of 1991.

# MONTHLY INDEX ECONOMIC ACTIVITY



NOTE: Adjusted for seasonal and random movements

# Unemployment Rate 1978-90



- 10b -

GRAPH 3

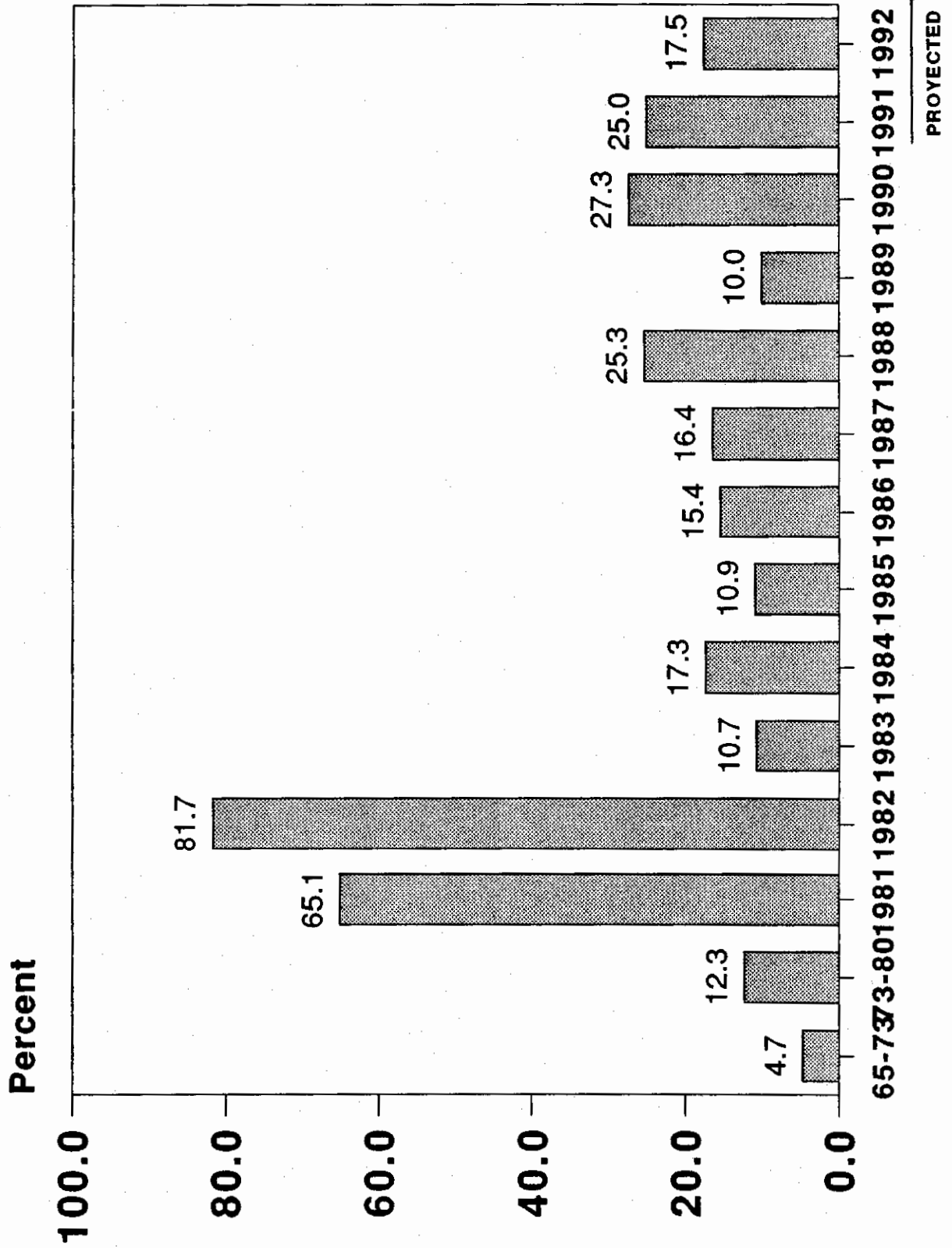
Source: La Academia de CentroAmerica

Note: The methodology changed in 1988

# Inflation

- 10c -

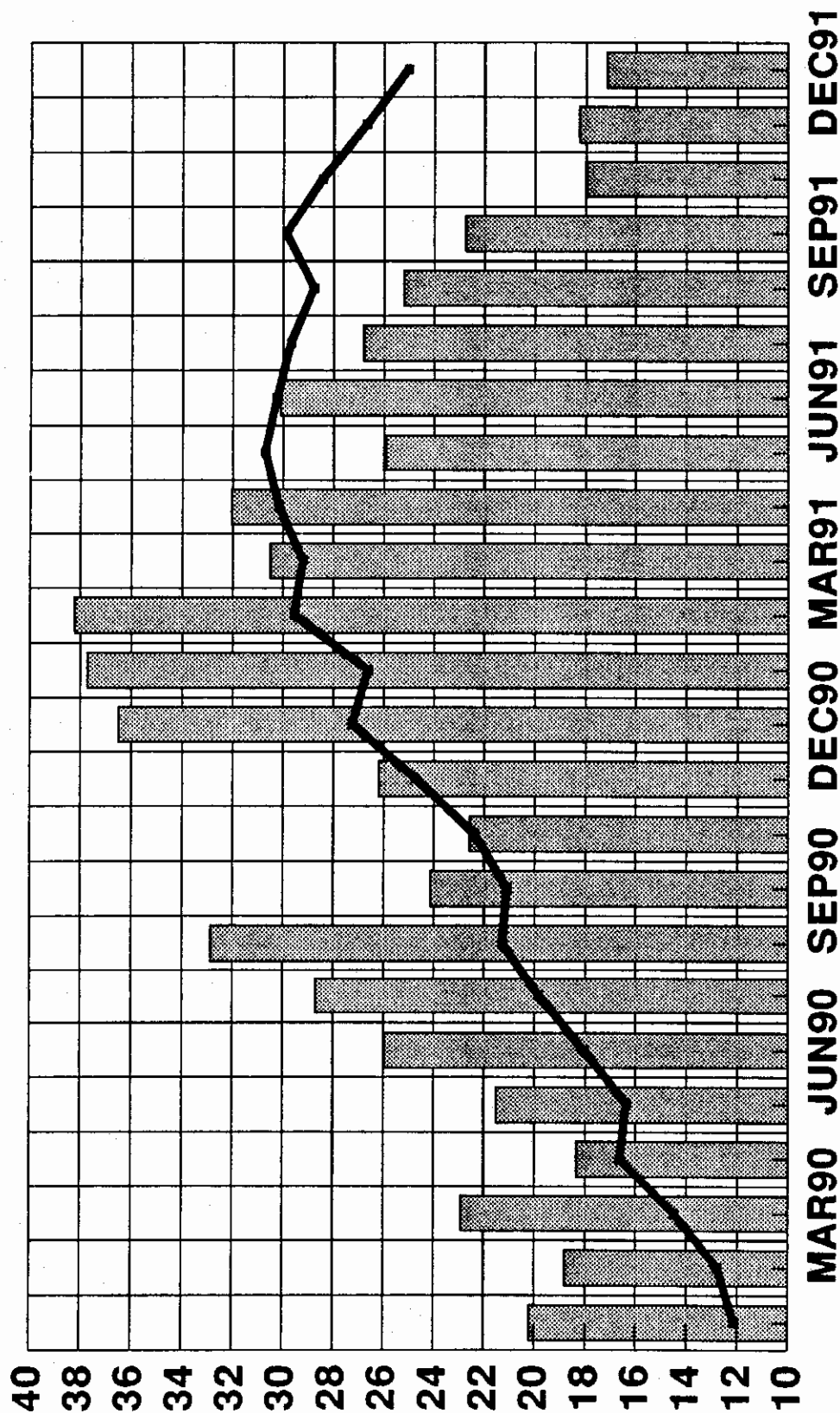
GRAPH 4



Consumer price index (Dec. to Dec.)

# INFLATION GENERAL CPI

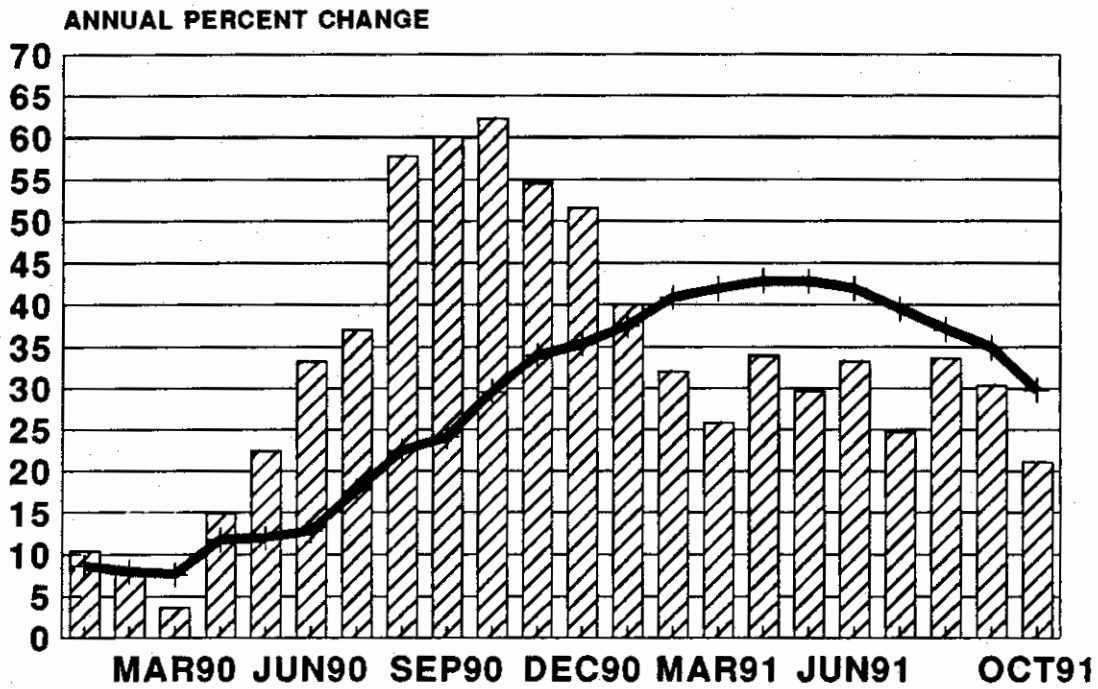
## ANNUAL PERCENT CHANGE



--- LAST 12 MONTHS ■ LAST 3 MONTHS

**INFLATION  
CONTROLLED CPI**

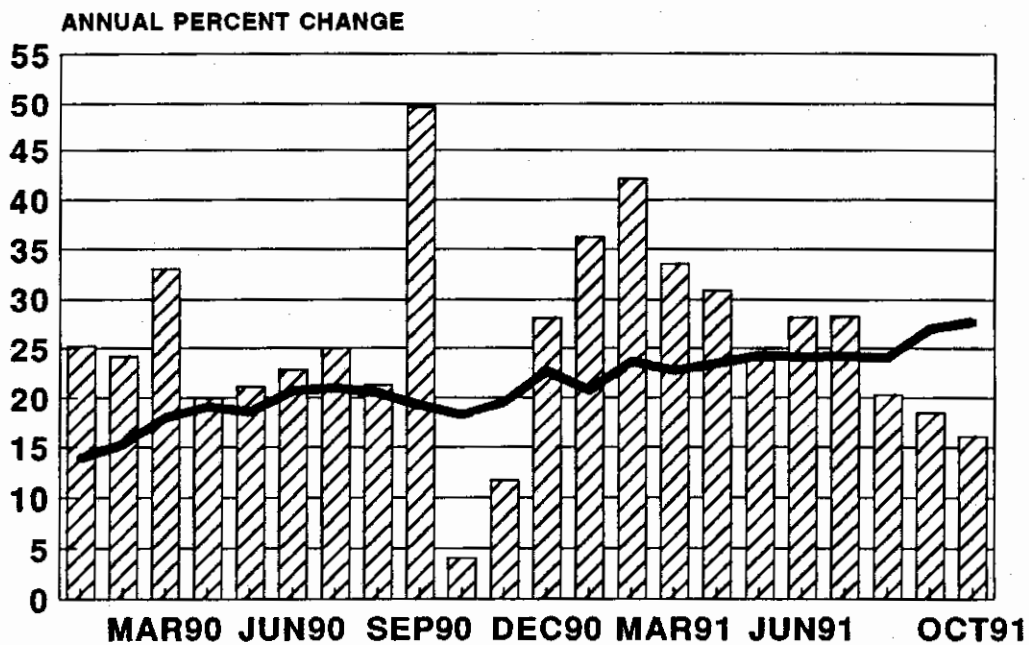
GRAPH 6



+ LAST 12 MONTHS    ▨ LAST 3 MONTHS

**INFLATION  
NON-CONTROLLED CPI**

GRAPH 7



+ LAST 12 MONTHS    ▨ LAST 3 MONTHS

As discussed below (section on Financial Intermediation), the Central Bank began to implement a more restrictive monetary policy in August 1990, but its full effect was not reached until March 1991. As the lags between changes in the monetary supply and its effect on inflation have been estimated at 6-12 months, the full effect on prices will not be felt until early 1992.

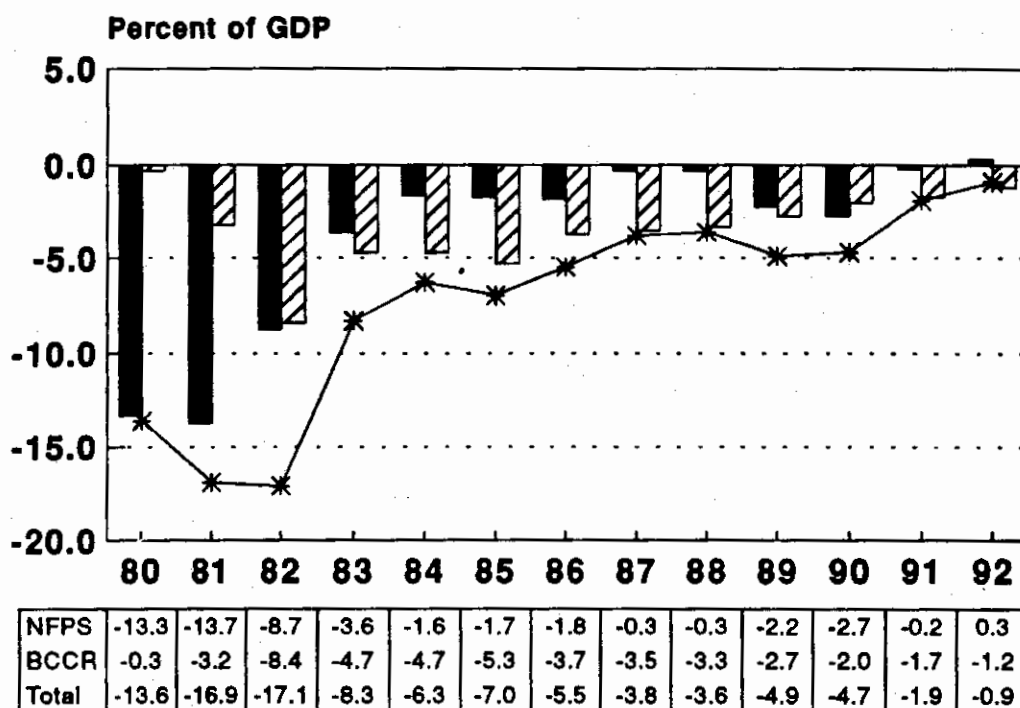
### 3. Public Sector Finances

The non-financial public sector (NFPS) of Costa Rica comprises the Central Government; about 100 decentralized agencies, of which the most important is the social security system (CCSS); 84 municipalities; and 13 state-owned enterprises (SOEs), of which the most important are the state-owned oil refinery (RECOPE), the electricity and telephone company (ICE), the state marketing agency (CNP), and the social protection council (JPSSJ). The Central Bank, although not a part of the non-financial public sector, has carried out quasifiscal functions, financing the deficit of the public sector and acquiring some of the debt of the NFPS as part of the debt renegotiations with the commercial banks. These past activities of the Central Bank have resulted in a balance sheet where the interest earning assets are significantly lower than the interest bearing liabilities. The annual losses of the Central Bank are a source of financial instability, and therefore the IMF program includes Central Bank losses in the definition of the public sector deficit. Historic data on public sector finances are given in Graphs 8 and 9. Graph 8 shows the balances of the non-financial public sector and the Central Bank. This deficit declined steadily until 1988, it increased in 1989 and 1990, the result of the fiscal policies of the Arias Administration, and will be lowered sharply in 1991. Graph 9 shows the balance of the non-financial public sector, i.e., the public sector excluding the Central Bank. The Central Government deficit (Govern) has remained quite high, but this has been compensated by a large surplus of the rest of the non-financial public sector (RNFPS). Tables 1 and 2 provide detailed data on the operations of the consolidated public sector.

The centerpiece of the 1991 macroeconomic adjustment program supported by the IMF was a sharp reduction of the public sector deficit (including Central Bank losses) from 4.7 percent of the GDP in 1990 to 0.5 percent of the GDP in 1991. The fiscal program, which was executed successfully, consisted of:

a. a tax package which broadened the base of the sales tax and increased rates temporarily to 13 percent in 1991, with scheduled reductions to 12 percent in 1992, to 11 percent in 1993 and to 10 percent in 1994 (passed in February 1991);

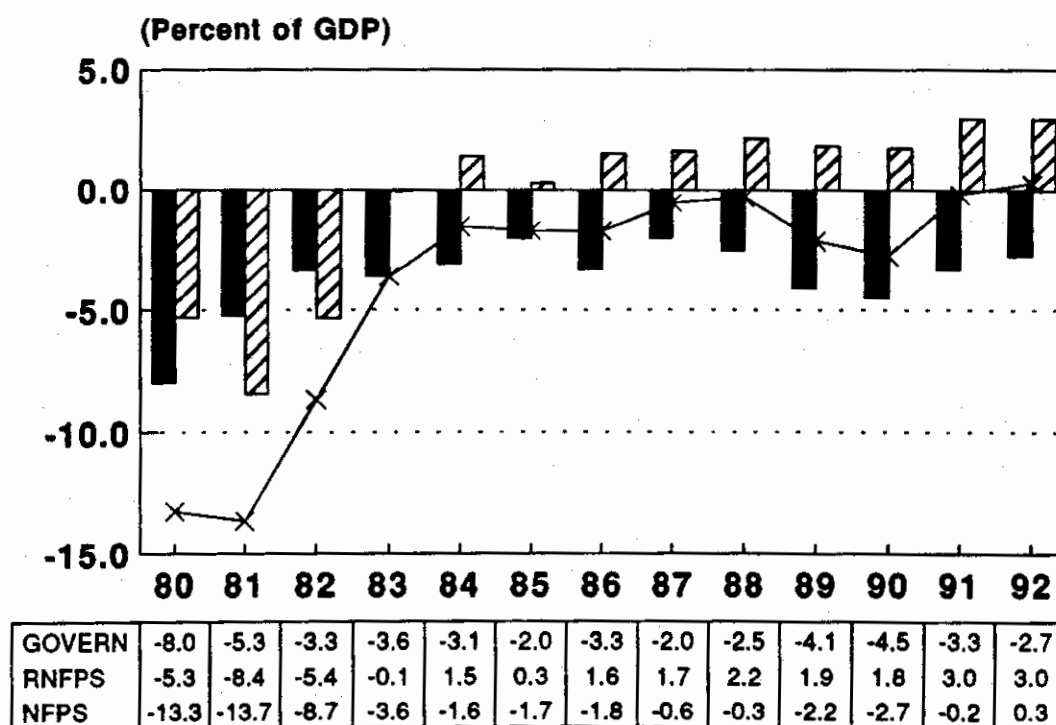
# Operations of the Public Sector



■ NFPS ▨ BCCR \* Total

GRAPH 9

## Non-financial Public Sector Balance



■ GOVERN ▨ RNFPS \* NFPS

TABLE 1

# OPERATIONS OF THE CONSOLIDATED PUBLIC SECTOR

(In million colones)

	1985	1986	1987	1988	1989	1990	1991	1992
<b>Central Government</b>								
TOTAL REVENUE	32,005	38,029	44,642	54,200	65,100	76,010	102,000	123,200
Expenditures								
Of which,								
Wages and salaries	10,980	13,651	15,611	18,983	23,734	30,238	36,678	42,913
Transfers	12,727	15,218	17,664	22,598	29,053	35,180	40,522	48,200
CATs	676	975	2,396	1,790	4,295	5,932	6,965	6,000
Pensions	2,288	2,946	4,570	5,798	7,513	9,867	13,280	16,090
Transfers to Universities	2,857	3,535	4,191	4,780	5,792	6,900	8,477	10,010
Other transfers	6,906	7,762	6,507	10,230	11,453	12,481	11,800	16,100
Interest on domestic debt	1,833	3,207	4,391	5,860	8,201	12,650	22,200	26,250
TOTAL EXPENDITURES	35,945	46,275	50,356	63,035	82,430	99,143	122,500	144,250
CENTRAL GOVERNMENT BALANCE	(3,940)	(8,246)	(5,714)	(8,835)	(17,330)	(23,133)	(20,500)	(21,050)
<b>Rest of Non-financial</b>								
<b>Public Sector</b>								
CCSS	2,845	3,106	3,202	2,710	5,157	2,665	5,145	8,000
RECOPE	(425)	1,029	1,257	2,589	492	2,035	7,005	7,692
ICE	246	49	1,204	2,228	2,835	3,275	8,600	8,805
CNF	(1,390)	(134)	(781)	(396)	(503)	(664)	(1,200)	(830)
JFSSJ	(62)	65	151	152	242	277	266	170
Subtotal of five agencies	1,214	4,115	5,033	7,283	8,223	7,588	19,816	23,837
Other NFPS	(676)	(208)	(158)	454	(254)	1,489	(791)	(112)
TOTAL Rest of NFPS	538	3,907	4,875	7,737	7,969	9,077	19,025	23,725
BALANCE ON NON-FINANCIAL PUBLIC SECTOR	(3,402)	(4,339)	(839)	(1,098)	(9,361)	(14,056)	(1,475)	2,675
CENTRAL BANK BALANCE	(10,521)	(9,260)	(9,916)	(11,656)	(11,570)	(10,067)	(10,455)	(9,737)
Of which, cash losses	(13,618)	(2,870)	(3,540)	(4,856)	(6,330)	(37,941)	(17,364)	(10,104)
PUBLIC SECTOR BALANCE	(13,923)	(13,599)	(10,755)	(12,754)	(20,931)	(24,123)	(11,930)	(7,062)
<b>PERCENTAGE OF GDP</b>								
Central Government	-2.0%	-3.3%	-2.0%	-2.5%	-4.1%	-4.5%	-3.3%	-2.7%
Rest of non-financial public sector	0.3%	1.6%	1.7%	2.2%	1.9%	1.8%	3.0%	3.0%
TOTAL NFPS	-1.7%	-1.8%	-0.3%	-0.3%	-2.2%	-2.7%	-0.2%	0.3%
Central Bank	-5.3%	-3.7%	-3.5%	-3.3%	-2.7%	-2.0%	-1.7%	-1.2%
TOTAL	-7.0%	-5.5%	-3.8%	-3.6%	-4.9%	-4.7%	-1.9%	-0.9%
Memorandum Item: GDP a/	197,920	247,752	284,852	355,968	426,634	515,000	630,000	789,000

a/ Estimates from Ministry of Finance

SOURCE: Ministry of Finance and Central Bank.

TABLE 2

# OPERATIONS OF THE CONSOLIDATED PUBLIC SECTOR

( ANNUAL % CHANGE )

	1986	1987	1988	1989	1990	1991	1992
<b>Central Government</b>							
TOTAL REVENUE	18.82	17.39	21.41	20.11	16.76	34.19	20.78
Expenditures							
Of which,							
Wages and salaries	24.33	14.36	21.60	25.03	27.40	21.30	17.00
Transfers	19.57	16.07	27.93	28.56	21.09	15.18	18.95
CATs	44.23	145.74	-25.29	139.94	38.11	17.41	-13.85
Pensions	28.76	55.13	26.87	29.58	31.33	34.59	21.16
Transfers to Universities	23.73	18.56	14.05	21.17	19.13	22.86	18.08
Other transfers	12.40	-16.17	57.22	11.96	8.98	-5.46	36.44
Interest on domestic debt	74.96	36.92	33.45	39.95	54.25	75.49	18.24
TOTAL EXPENDITURES	28.74	8.82	25.18	30.77	20.28	23.56	17.76
CENTRAL GOVERNMENT BALANCE	109.29	-30.71	54.62	96.15	33.49	-11.38	2.68
<b>Rest of Non-financial</b>							
<b>Public Sector</b>							
CCSS	9.17	3.09	-15.37	90.30	-48.32	93.06	55.49
PECOPE	-342.12	22.16	105.97	-81.00	313.62	244.23	9.81
ICE	-80.08	2357.14	85.05	27.24	15.52	162.60	2.38
CNP	-90.36	482.84	-49.30	27.02	32.01	80.72	-30.83
JPSSJ	-204.84	132.31	0.66	59.21	14.46	-3.97	-36.09
Subtotal of five agencies	238.96	22.31	44.70	12.91	-7.72	161.15	20.29
Other NFPS	-69.23	-24.04	-387.34	-155.95	-686.22	-153.12	-85.84
TOTAL Rest of NFPS	626.21	24.78	58.71	3.00	13.90	109.60	24.70
BALANCE ON NON-FINANCIAL PUBLIC SECTOR	27.54	-80.66	30.87	752.55	50.15	-89.51	-281.36
CENTRAL BANK BALANCE	-11.99	7.08	17.55	-0.74	-12.99	3.85	-6.87
Of which, cash losses	-78.92	23.34	37.18	30.35	499.38	-54.23	-41.81
PUBLIC SECTOR BALANCE	-2.33	-20.91	18.59	64.11	15.25	-50.55	-40.80
Memorandum Item: GDP a/	25.18	14.97	24.97	19.85	20.71	22.33	25.24

a/ Estimates from Ministry of Finance

SOURCE: Ministry of Finance and Central Bank.

b. a temporary import surcharge of 10 percent (a surcharge can be imposed by the Central Bank, i.e., it does not require approval by the Legislative Assembly), which was eliminated in August 1991;

c. an increase in the price of oil derivatives produced by the state-owned oil refinery (RECOPE) of 13 percent in excess of cost increases took place at the beginning of 1991;

d. monthly increases in electricity rates of 1.8 percent have been implemented;

e. an increase of 10 percent in basic telephone rates took place at the beginning of 1991;

f. a reduction in public sector employment of 7,000 in 1991 by the end of the year;

g. an increase of public sector wages of only 5 percent in January and of 5 percent in June 1991, an adjustment below the inflation rate, were made; and

h. a law to tax export subsidies was passed by the Legislative Assembly on October 7, 1991.

A number of measures which were part of the original fiscal package were not implemented early in 1991 as planned. These are:

a. only one of two laws to tax high public pensions was enacted by the Legislative Assembly. High pensions that are paid through the teacher's pension system out of the Treasury are now taxed on a sliding scale, as a "contribution to the fund" which in essence returns funds to the Treasury. This law was passed in November 1991. In addition to this, a bill is currently being debated in the Assembly which seeks to regulate the pension systems paid directly by the Treasury and includes a modification to the present income tax law that will tax pensions for the first time and at the same rate as salaries. This law, as of mid-December 1991, is in heated first debate at the National Assembly and is not likely to be voted on until late January 1992. There does not appear to be any fundamental disagreement on the issue of taxing pensions. Rather, the fact that the bill also calls for the eventual unification of most public pensions into the social security system, (excluding the Judiciary, Legislators, ex-Presidents and teachers' pensions) poses a major constraint to approving this legislation.

b. a law to increase tax collections through an increase in penalties was not enacted by the Legislative Assembly;

c. a reduction in transfers to the universities from the level agreed by the Arias administration in 1989 was not implemented after President Calderon reversed a decision of his Minister of Finance (the Minister resigned after this);

d. a salary increase to teachers which was granted at the end of Arias administration was not postponed, as had been agreed with the IMF; and

e. the reduction in public employment did not take place on schedule, and therefore, although 7,000 positions probably will be eliminated, the fiscal effect will be less than if the reductions had taken place in early 1991.

Additionally, government expenditures were higher than envisaged early in 1991 because of the costs associated with the damage caused by the earthquake of April 1991, and the unusually heavy rains of August 1991.

The data for 1990-1991, and projections for 1992 are (in percentage of GDP):

	1990 Passive <sup>1/</sup>	1990 Actual	1991 IMF Program	1991 Forecast	1992 Passive <sup>1/</sup>	1992 IMF Program <sup>2/</sup>
Central Gov.	-4.5	-4.5	-2.0	-3.3	-3.7	-2.7
Rest of Non- financial public sector	-0.4	1.8	3.2	3.0	2.9	3.0
Total NFPS	-4.9	-2.7	1.2	-0.2	-0.8	0.3
Central Bank	-2.2	-2.0	-1.8	-1.7	-1.4	-1.2
Total Public Sector <sup>3/</sup>	-7.1	-4.7	-0.5	-1.9	-2.2	-0.9

<sup>1/</sup> Deficit if no policy measures are implemented.

<sup>2/</sup> Program under discussion.

<sup>3/</sup> Numbers may not add up due to rounding.

If measures designed to improve the fiscal situation continue to be implemented in November and December 1991, the overall public sector deficit may reach 1.9 percent of the GDP, compared to an original IMF target of 0.5 percent of the GDP, and to an IMF revised target of 1.5 percent of the GDP. The largest deviation between performance and the original IMF target was in the Central Government whose deficit in 1991 is expected to be 3.3 percent of the GDP, compared to a program target of 2.0 percent. (Graphs 8 and 9.)

Central Government. Data on the revenue and expenditures of the Central Government are:

<u>Central Government</u>	<u>1990</u>	<u>Program 1991</u>	<u>Min.of Finance Forecast 1991</u>
	(million colones)		
Revenue	76,010	104,100	102,000
Expenditures	99,143	116,400	122,500
Balance	-23,133	-12,300	-20,500

Nominal Rates of Growth

	(percentages)	
Revenue	37.0	34.2
Expenditures	17.4	23.6
Inflation (average) 1/	15.0	26.0

Real Rates of Growth

Revenue	19.1	6.5
Expenditures	2.1	-1.9

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1/ Program assumption and latest estimate.

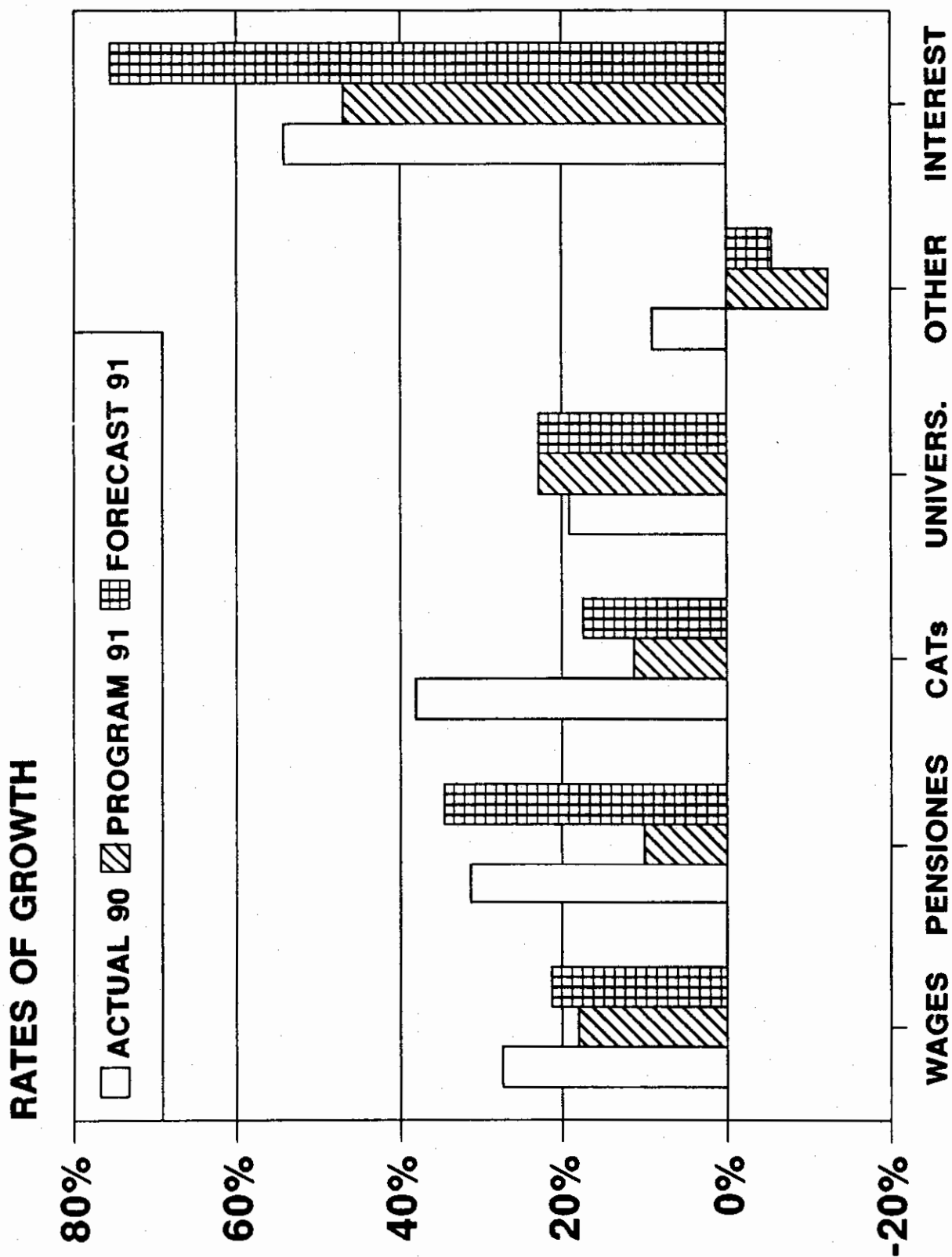
Revenue in 1991 is expected to increase by 34 percent with respect to 1990, compared to an IMF program estimate of 37 percent. The IMF target for expenditures growth in 1991 was 17.4 percent, while actual growth is expected to be 23.6 percent. Inflation, however, was much higher than what was envisaged when the program was designed. The expenditure target of the IMF program would have resulted in an increase in expenditures in real terms of 2.1 percent, if average inflation had been 15 percent. It is expected that expenditures will actually decline by 1.9 percent in real terms in 1991, a result of the higher level of inflation. Of course, this decline can not be considered "good" economic performance, as it was the result of accelerating inflation which was a consequence of the high public sector deficit.

The fastest growing expenditure items in the Central Government in 1991 were interest on the domestic debt (75 percent) and pensions (35 percent). The interest payments on the domestic debt increased from 12.6 billion colones in 1990 to a projected 22.2 billion colones in 1991, or by almost 10 billion colones; this increase is greater than total expected transfers to the universities in 1991 (8.5 billion colones). Unless the deficits decline, the interest payments on the domestic debt will continue to grow rapidly. To control the rapid expansion of pension expenditures, it will be necessary to enact legislation which is presently in the Legislative Assembly. The first component of the Administration's three-part package of pension reform legislation, the Teacher's Pension Reform was passed on November 11, 1991, and the other two parts, the General Law and a law governing the regulation of private sector pensions, are expected to pass during the present extraordinary session (December 1991 through April 1992). The growth rates of the main Central Government expenditure items are given in Graph 10.

Rest of Non-Financial Public Sector. The deviation between the program and the forecast for 1991 for the rest of the non-financial public sector (all institutions except the Central Government and the Central Bank) was minor. Only two institutions performed significantly worse than expected - the Social Security Agency (Caja Costarricense del Seguro Social, CCSS) and the Grain Marketing Agency (Consejo Nacional de Produccion, CNP). The surplus of the CCSS will be about 1,500 million colones lower than the program estimates, the result of a "laudo arbitral" for physicians (cost of 1,000 million colones), and expenses related to the earthquake, including the repair of a hospital (100 million colones), and increased expenditures for medicines. In the CNP, trading losses have increased and the revenue associated with the operation of recently privatized retail stores ("estancos") has declined. Parenthetically, the privatization of the CNP's 157 retail stores, with direct AID technical assistance and financial support, has been successful and stands as the Calderon's Administration first and most significant privatization effort.

# CENTRAL GOVERNMENT: MAIN EXPENDITURES

- 15a -  
GRAPH 10



This privatization was carried out in a highly charged political atmosphere and stands as one of this Administration's major accomplishments.

Central Bank. The interest paying assets of the Central Bank of Costa Rica (BCCR) are lower than the interest-bearing liabilities, and therefore the BCCR generates perennial losses. This situation is the result of a series of activities carried out in the past which included: (a) exchange rate subsidies (the BCCR sold foreign exchange for some purposes such as purchases of pharmaceuticals, oil purchases and foreign debt service at a price lower than the purchase price); (b) the Central Bank assumed the foreign exchange risk of long-term loans; (c) the central Bank financed the operations of CODESA, a holding company for state-owned enterprises; (d) the Central Bank financed the losses of the CNP, the grain marketing agency; and (e) the Central Bank financed trade with Nicaragua, and this debt does not pay interest and has a low value in the secondary market. The quasi-fiscal activities of the BCCR have resulted in losses which increase the monetary base and therefore contribute to inflation.

The 1992 Fiscal Program. The GOCR authorities have entered into negotiations with the IMF for an extension of the present Stand-by Arrangement into 1992. The program would require a lowering of the public sector deficit from an estimated 1.9 percent in 1991 to one percent in 1992. Achieving this would require the continuation of a restrictive public sector wage policy, labor mobility, the passage of legislation to rationalize tax exonerations (expected revenue increase of 8,000 million colones), and the establishment of an import duty on oil (expected yield of 3,500 million colones).

These increases in revenue are required to compensate for a lowering of the sales tax from 13 to 12 percent (estimated loss in revenue 3,200 million colones), an elimination of import duty surcharges (estimated loss in revenue of 4,400 million colones) and tariff reductions (estimated loss in revenue of 1,000 million colones).

#### 4. Financial Intermediation

During the first half of 1990, bank credit expansion increased rapidly even though the legal reserve requirement was being increased by one percentage point per month, reaching 31 percent for sight deposits at the end of August. The increase in bank credit was based on an increase in the commercial bank float with the Central Bank, fueled by a mechanism known folklorically as the "bicicleta," which had two elements. First, state-owned banks exchanged cashier's checks, and while the receiving bank's account at the Central Bank was credited the day the check was presented, the account of the bank issuing bank to use its increased liquidity to purchase Central Government bonds. Second, state-owned banks purchased Central Government bonds

with cashier's checks. While the account of the Central Government at the Central Bank was credited the same day the bond was purchased, the account of the bank that purchased the bond was not debited until the following working day. These transactions were repeated daily, and their circular nature gave the "bicicleta" its name. We understand that while this happened, the Central Bank and the Auditor General of Financial Institutions "looked the other way." The use of the "bicicleta" was the equivalent of financing the public sector deficit by the Central Bank, i.e., the deficit was monetized. Graph 11 shows the float as a percent of liabilities subject to reserve requirements. Reducing the "bicicleta" was one of the earliest corrective measures taken by the Calderon Administration. This reduction, however, had to be accompanied by a reduction in the legal reserve requirement on sight deposits from 31 percent to 15 percent in September 1990, in order to avoid a sharp reduction in liquidity. In a sense, the Central Bank action legalized the "bicicleta," and the excess liquidity caused by that mechanism was eliminated over six months.

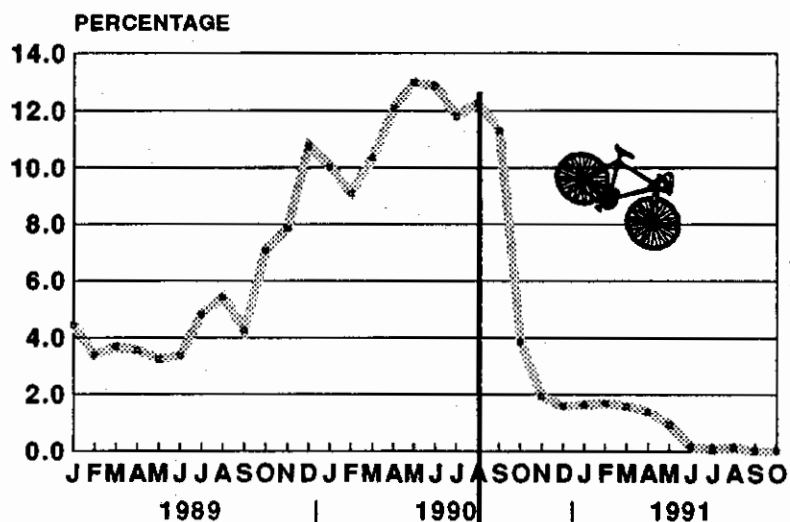
Another mechanism to finance the public sector indirectly emerged in mid 1990. Bank regulators permitted the commercial banks to count as reserves Central Government overdrafts as well as past-due government bonds. This was permitted at a time when Central Government liquidity was at an all time low, and the commercial banks were threatening to stop making payments on government checks. (Miguel Angel Rodriguez, President of the Legislative Assembly, has referred to this mechanism as the "patineta," or skateboard.) The development of the "patineta" is shown in Graph 12.

With the private credit freeze imposed at the end of August 1990, the rate of growth of net domestic assets of the banking system began to slow down (Graph 13). There was, however, a fairly strong increase in net bank credit expansion to the public sector. Moreover, Bank liabilities to the private sector fell in real terms, perhaps due to uncertainties about exchange rate policy, the sharp increase in inflation, and some disintermediation following the freeze on bank credit in August. Under these circumstances, the loss in net international reserves continued in the second semester, albeit at a lower rate than in the first semester, and for the year as a whole amounted to US\$514 million.

In early 1991, after the passage of the tax package and with the sharp increase in the surplus of the state-owned enterprises, the fiscal situation began to improve markedly, and this permitted the implementation of a more restrictive monetary policy. Graph 13 shows the effect of the improved fiscal situation on the growth of net domestic assets of the banking system in the first semester of 1991. Additionally, by

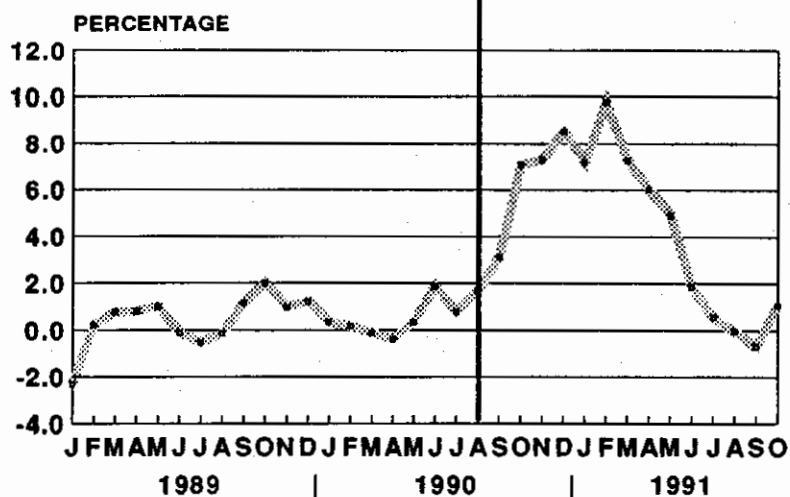
GRAPH 11

**FLOAT IN RELATION TO LIABILITIES SUBJECT  
TO REQUIREMENT  
"BICICLETA"**



GRAPH 12

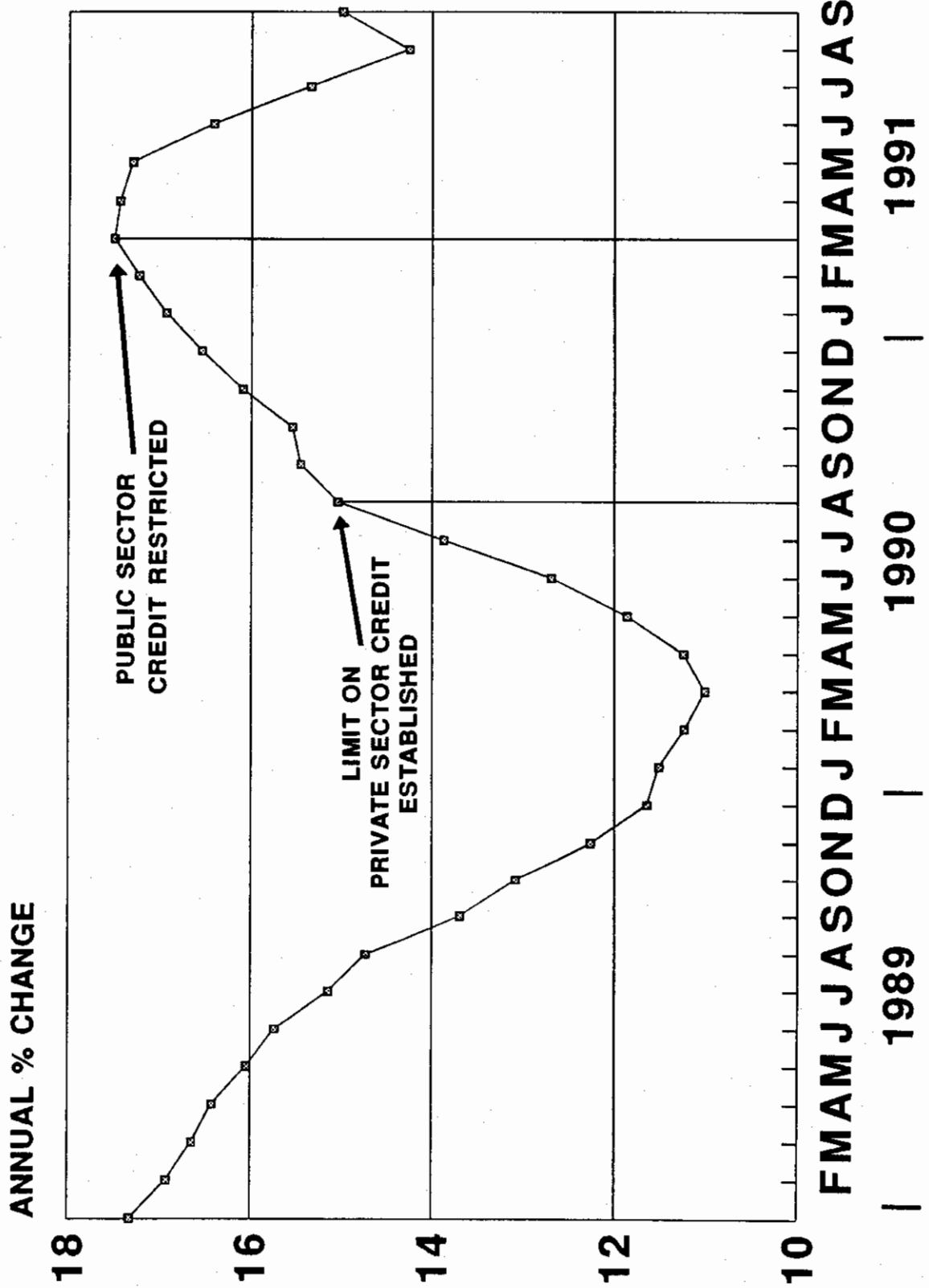
**DIFFERENCE IN RELATION TO LIABILITIES  
SUBJECT TO REQUIREMENT**



Legal reserves reported by commercial  
banks to bank supervisory agency minus  
actual reserves deposited at the BCCR

# BANKING SYSTEM: NET DOMESTIC ASSETS SEASONALLY ADJUSTED

- 17b -  
GRAPH 13



September 1991, and due to the improvement in public sector finances and the finance obtained from the second disbursement of SAL II (US \$66 million), the use of the "patineta" was discontinued.

An analysis of the sources of change in liquidity is presented in Graph 14. In 1990, liquidity was increasing entirely as a result of increases in credit and in "net other assets" (NOAs). In 1991, as a result of the improved fiscal situation, liquidity increases were due almost entirely to the accumulation of net official reserves (NORs).

Real interest rates varied widely in 1990 and early 1991. Since June 1991, however, they have increased steadily, and are now between 12 and 15 percent depending on the indicator used to determine inflation expectations (Graph 15).

#### 5. Balance of Payments

Since the economic crisis of 1981, Costa Rica has implemented policies designed to enhance the role of competitive market forces in resource allocation, resulting in major positive effects on export growth, particularly non-traditional exports. In 1986, the value of exports of non-traditional commodities surpassed the value of coffee, and in 1988 it surpassed the value of all traditional exports combined.

Since 1982, the current account deficit has fluctuated widely, but has widened steadily from US\$250 million in that year to US\$584 million in 1990. The 1987-90 actual data and the projections for 1991 and 1992 are (in US\$ million):

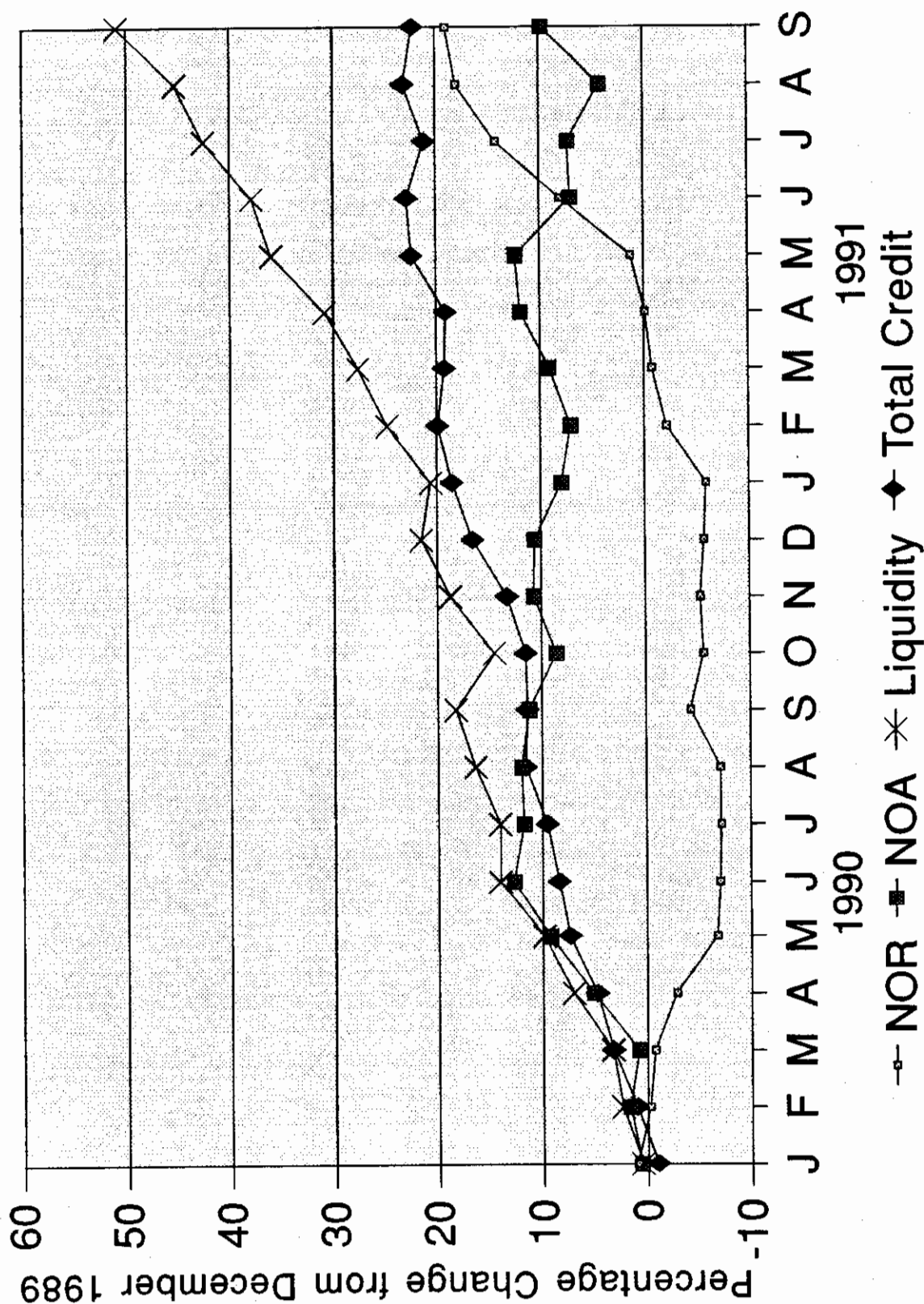
	<u>1987</u>	<u>1988</u>	<u>1989</u>	<u>1990</u>	<u>1991</u>	<u>1992</u>
Current Account	-408.5	-311.7	-465.6	-583.8	-131.6	-214.0
Of which, trade balance	-282.4	-239.5	-429.7	-671.4	-345.3	-427.0
Capital Account	-202.4	-150.4	10.6	-260.6	260.6	113.8
Of which, private capital	114.1	179.9	359.6	186.7	257.6	175.0
Balance of Payments Support	120.0	125.0	105.0	105.0	90.4	130.0
Of which, AID	120.0	125.0	65.0	70.0	24.0	30.0
Rescheduling	42.9	108.6	229.7	1071.7	305.8	0.0
Arrears Subject to Rescheduling	253.9	212.0	203.0	-869.7	-118.9	0.0
Overall Balance of Payments	-194.1	-16.5	82.7	-537.4	406.3	29.8
Net International Reserves (-increase)	194.1	16.5	-82.7	537.4	-406.3	-100.0
Unfinanced Gap	-0-	-0-	-0-	-0-	-0-	70.2

More detailed balance of payments data are given in Table 3.

# SOURCES OF CHANGE IN LIQUIDITY

- 18a -

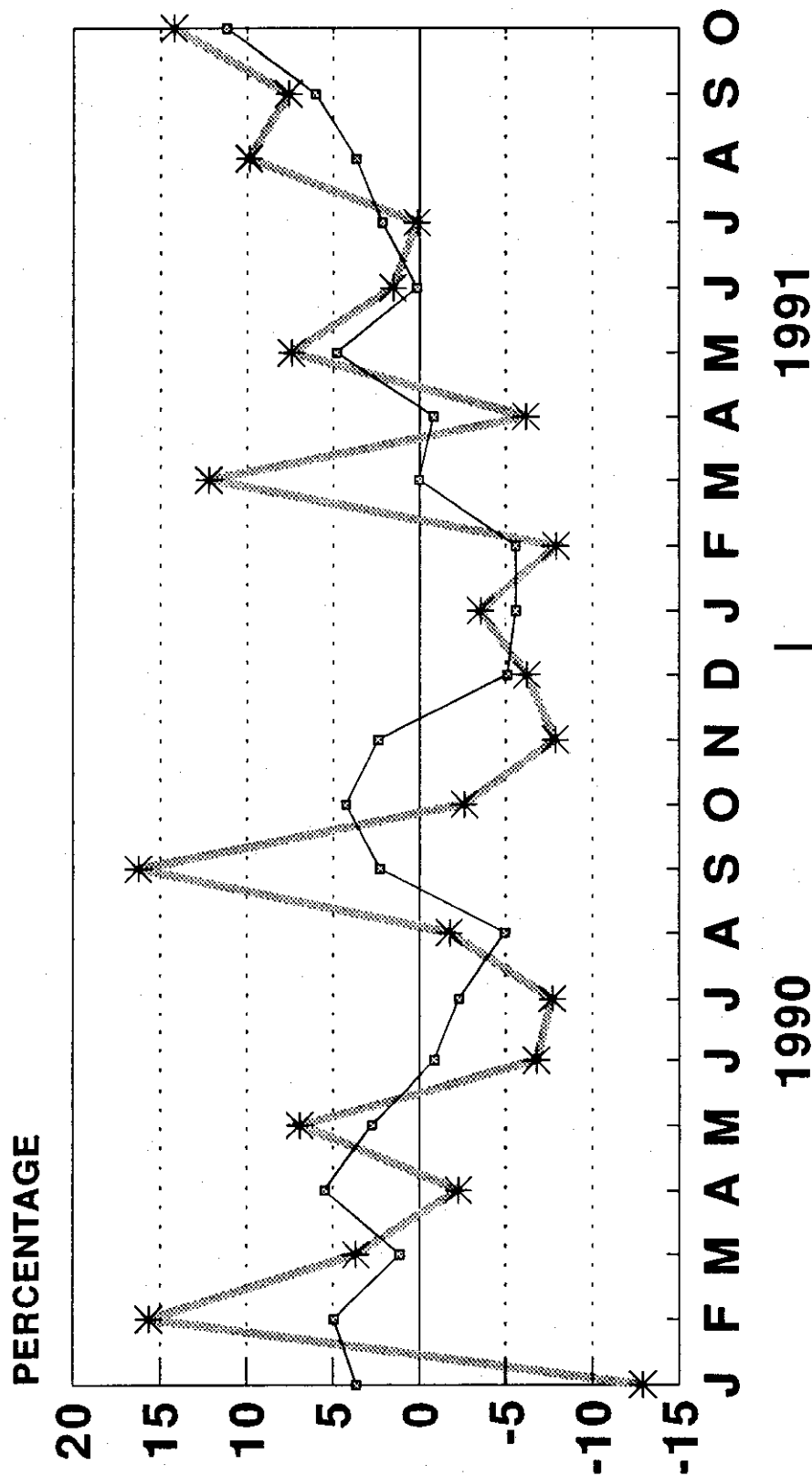
GRAPH 14



NOTE: Net official reserves converted to colones at the average exchange rate of each month

# REAL DEPOSIT INTEREST RATE AT PRIVATE BANKS 6 MONTHS RATE

- 18b -  
GRAPH 15



NOTE: Interest rate is net of taxes

TABLE 3

# **BALANCE OF PAYMENTS** -In million of dollars-

	1987	1988	1989	Prelim. 1990	Estim. 1991	Proj. 1992
<b>CURRENT ACCOUNT</b>	-408.5	-311.7	-465.6	-583.8	-131.6	-214.0
Trade Balance	-282.4	-239.5	-429.7	-671.4	-345.3	-427.0
Exports, fob	1106.4	1180.7	1322.7	1365.6	1503.0	1606.1
Imports, cif	-1388.8	-1420.2	-1752.4	-2037.0	-1848.3	-2033.1
Factor Payments	-295.4	-325.3	-356.0	-283.1	-203.9	-234.6
Official interest due	-284.7	-303.4	-298.3	-261.2	-219.8	-246.2
Other	-10.7	-21.9	-57.7	-21.9	15.9	11.6
Other services and non-balances of payments transfers	169.3	253.1	320.1	370.7	417.6	447.6
<b>CAPITAL ACCOUNT</b>	-202.4	-150.4	10.6	-260.6	260.6	113.8
Public	-316.5	-330.3	-349.0	-447.3	2.7	-61.2
Disbursements	83.8	96.4	87.6	152.7	243.6	172.0
Amortization due	-400.3	-426.7	-436.6	-600.0	-240.9	-233.2
Private	114.1	179.9	359.6	186.7	257.9	175.0
<b>BALANCE OF PAYMENTS SUPPORT</b>	120.0	125.0	105.0	105.0	90.4	130.0
U.S. AID (ESP)	120.0	125.0	65.0	70.0	24.0	30.0
IBRD (SAL)	0.0	0.0	40.0	35.0	66.4	100.0
<b>OVERALL BALANCE OF PAYMENTS BEFORE DEBT RELIEF</b>	-490.9	-337.1	-350.0	-739.4	219.4	29.8
<b>RESCHEDULING</b>	42.9	108.6	229.7	1071.7	305.8	0.0
Current obligations	21.8	25.0	15.1	163.6	79.4	0.0
Past obligations	21.1	83.6	214.6	908.1	226.4	0.0
<b>ARREARS SUBJECT TO RESCHEDULING (+ INCREASE)</b>	253.9	212.0	203.0	-869.7	-118.9	0.0
<b>OVERALL BALANCE OF PAYMENTS AFTER DEBT RELIEF</b>	-194.1	-16.5	82.7	-537.4	406.3	29.8
<b>NET INTERNATIONAL RESERVES</b>	194.1	16.5	-82.7	537.4	-406.3	-100.0
Nonrefinanciable arrears (+ increase)	118.4	121.4	-67.7	212.0	-221.3	-51.6
Net official reserves (- increase)	75.7	-104.9	-15.0	325.4	-185.0	-48.9
Net use of fund credit	-40.1	-60.9	-33.4	-23.3	68.5	1.1
Other net official reserves	115.8	-44.0	18.4	348.7	-253.5	-50.0
<b>Financing Gap</b>	0.0	0.0	0.0	0.0	0.0	70.2

SOURCE: Central Bank of Costa Rica.

In 1990, lower export prices for coffee and slower growth of non-traditional exports (6 percent compared to more than 20 percent in 1989) resulted in a stagnation of export growth which is a result of low economic growth in the U.S. Imports, meanwhile, grew by 16 percent in U.S. dollar terms, the result of an expansionary policy and of the appreciation of the real effective exchange rate in 1989 and early 1990. The capital account (excluding balance of payments support) deteriorated from a surplus of about US\$11 million in 1989 to a deficit of US\$261 million in 1990. This deterioration can be explained by delays in disbursements of SAL II, large payments related to the commercial bank debt-restructuring agreement, and a reduction in private capital inflows from the unusually high levels of 1989. In the last quarter of 1990, however, there was a sharp increase in private capital inflows, associated largely with investment in tourism facilities and banana plantations.

In 1991, exports are expected to increase in dollar terms, by 10.1 percent, and imports are expected to decline by 9.3 percent, and the current account deficit is expected to decline from US\$584 million in 1990 to US\$132 million in 1991. The decline in imports is the result of low economic growth, the devaluation of the real effective exchange rate, import surcharges, and prior deposits for imports. There was also an important improvement in the capital account, with private investment increasing from US\$187 million in 1990 to US\$258 million in 1991. Net international reserves are expected to increase by over US\$400 million.

The balance of payments projections for 1992 assume that imports will increase by 10 percent as a result of the need to increase inventory levels, lower tariffs, elimination of prior import deposits and the higher rate of GDP growth. We are assuming AID disbursements of US\$30 million, US\$20 million of TIP II and US\$10 million from ESR VIII which has not yet been disbursed. We are also assuming that the third disbursement of SAL II will be made in the first quarter of CY 1992 (US\$50 million) and that a first disbursement of SAL III will be made in the last quarter of CY 1992. To obtain an increase in reserves of US\$100 million, which is in the IMF program for 1992, additional financing of \$70 million would be required.

#### 6. International Reserves

In 1990, the net official reserve (NOR) position of the Central Bank deteriorated markedly. This deterioration was particularly rapid in the first five months of the year when reserves declined an average of US\$65 million per month (US\$36 million excluding the effects of the commercial debt buy-back). When

the Calderon Administration took office, the NORs were depleted and freely usable reserves were only the equivalent of about two weeks of imports of goods and non-factor services (Graph 16).

To maintain a minimum level of liquid reserves, the Central Bank was forced to lengthen the waiting period for importers to obtain foreign exchange. By the end of 1990, requests for foreign exchange in the Central Bank for more than 15 days ("presa over 15 days") reached US\$120 million.

In 1991, the "presa over 15 days" was reduced steadily, reaching zero in May, 1991 (see Graph 17). The accumulation of reserves has continued during 1991 (Graph 16), and although there was a slight decline of net official reserves in September, there was an increase of \$50 million in October. Net international reserves are expected to increase by over US\$400 million in 1991. The IMF program for 1992 is expected to require an increase in net international reserves of US\$100 million.

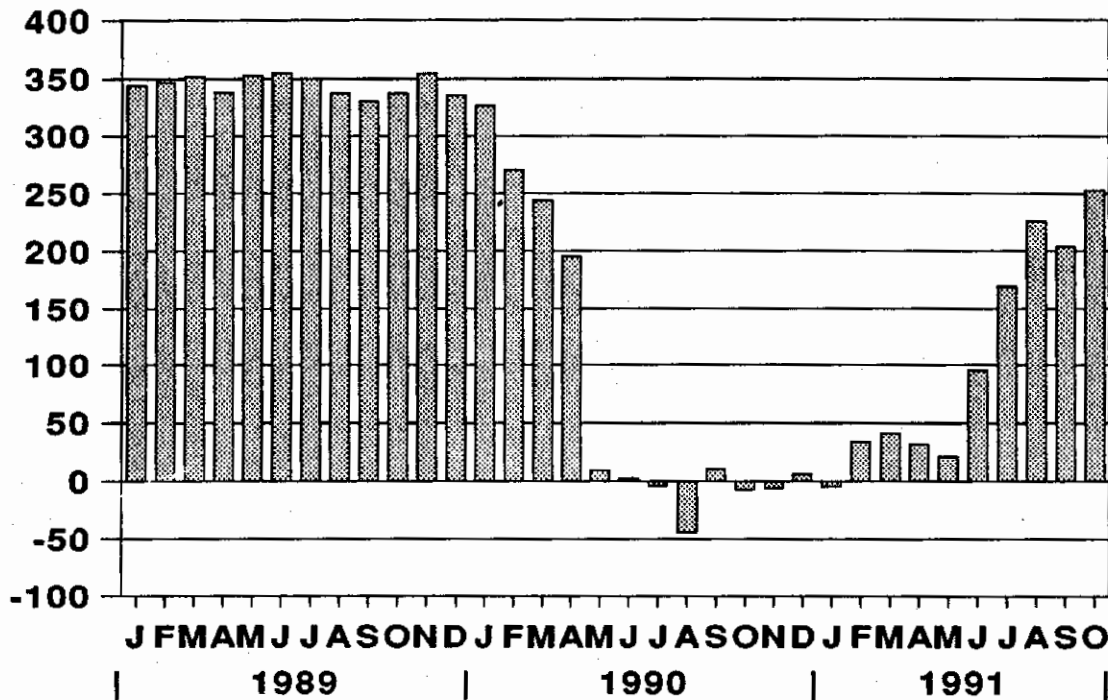
#### 7. Exchange Rate Developments

Costa Rica devalued the exchange rate sharply in 1981, but from that year to 1983 the real effective exchange rate appreciated. In 1985 the authorities began to implement a crawling peg policy whereby the exchange rate generally is adjusted to compensate for the difference between the inflation rate in Costa Rica and that of its main trading partners. This policy was effective in maintaining and/or enhancing international competitiveness until 1988. Mini-devaluations of the exchange rate continued during 1989, but were insufficient to compensate for domestic inflation vis-a-vis the inflation of Costa Rica's trading partners. The real effective exchange rate appreciated in real terms by 5 percent between December 1988 and December 1989.

Since the new Administration took office, the Central Bank sharply accelerated the rate of devaluation. During the period May 1990 to June 1991, the exchange rate was devalued by 28.2 percent vis-a-vis the US dollar, and by 19.8 percent vis-a-vis the currencies of Costa Rica's main trading partners, i.e., there was a nominal effective rate of devaluation of 19.8 percent. During that same time period, the devaluation of the real effective exchange rate was 8.2 percent. The coefficients of effectiveness with respect to the principal rate and to the effective rate are relatively low, 29 percent and 41 percent, respectively. The reason for the low effectiveness rate is, of course, that the domestic rate of inflation in Costa Rica has been quite high.

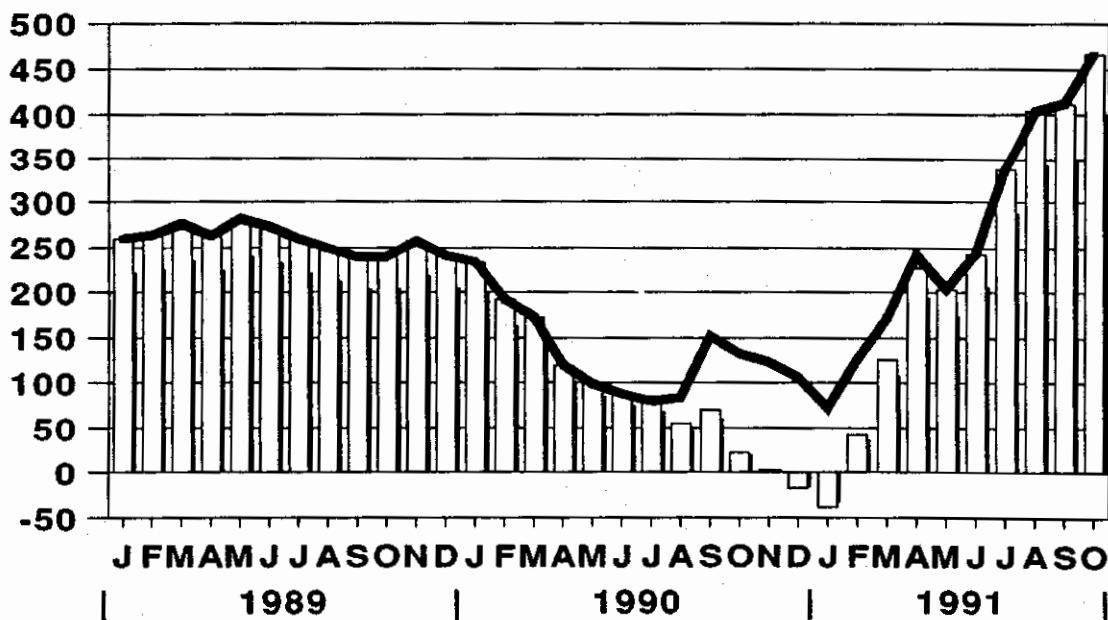
The recent real depreciation of the colon has resulted in a major improvement in the trade balance, and this has been accompanied by a major improvement in the capital account, mainly the result of a high level of foreign private investment which increased from US\$187 million in 1990 to an expected

**CENTRAL BANK: NET OFFICIAL RESERVES**  
In millions of U.S. dollars



GRAPH 17

**CENTRAL BANK: LIQUID RESERVES**  
In millions of U.S. dollars



→ LIQUID RESERVES    □ MINUS "PRESA"

US\$258 million in 1991. As result of the improvement of the current and capital accounts of the balance of payments, net international reserves have increased sharply.

With respect to future exchange rate policy, Sebastian Edwards, in a study financed by AID, ("Exchange Rate Policy and Macroeconomic Adjustment in Costa Rica, 1990-91, September 27, 1991") concludes that:

The recent real depreciation of the colon, coupled with the turnaround in international reserves and trade account have generated a somewhat comfortable external sector situation. The analysis of the RER index from historical perspective, the marked improvement in the trade account, and the relatively rapid accumulation of reserves, in fact, suggest that at this point there is no need for immediate further measures aimed at new real depreciations. In principle, and subject to the provisions that I discuss below, a reasonable approach for the next three to four months would be to (approximately) maintain the current real exchange rate situation. This would imply that a policy of devaluing the colon at approximately the rate of inflation differentials would be advisable in the immediate short run. <sup>1/</sup>

Three fundamental warnings should be made with respect to this policy. First, nominal exchange rate management should never be approached in a mechanical way, where a pre-determined formula is applied strictly. Experience in the most successful cases with managed exchange rates, such as Colombia and Korea, indicate in an unmistakable way that it is crucial to constantly monitor a broad set of external indicators. If they show signs of deterioration that go beyond a very temporary situation, the rate of devaluation should rapidly be revised. In the case of Costa Rica this means that special attention should be paid to reserves, the parallel market premium and other external sector indicators, such as imports. More specifically, if the recent and future external sector deregulation policies - the elimination of the 10 percent imports surcharge and the reduction in prior imports deposit - spur imports a revision of the policy should be undertaken, and measures towards avoiding overvaluation should be rapidly implemented.

Second, it is very important to be aware that a policy of devaluing the domestic currency according to inflation rate differentials has the risk of resulting in an inflation-devaluation spiral, where the ongoing rate of devaluation is not only perpetuated but accelerated. This means that the fact that a devaluation policy aimed at (approximately) maintaining the current level of the real exchange rate could be implemented in the next few months should not result in a relaxation of the efforts to solve the fiscal situation.

Third, if there are important changes in the "fundamental" determinants of the equilibrium real exchange rate - and especially the terms of trade - during the next few months, the exchange rate policy should be modified to reflect these changes.

In terms of medium term exchange rate policy, it is very important to have in mind that the future tariff reduction process - much of which is already planned in some detail - will require further real exchange rate depreciations. From a strategic policy planning perspective it is fundamental to begin considering, at this point, the specific way in which this issue will be handled. The government - and more specifically the Central Bank - should engage in a study that allows to have an estimation of the approximate magnitude of this required devaluation, and of alternative ways of implementing it.

In particular, it would be important to evaluate the desirability of handling that adjustment via an acceleration in the rate of mini-devaluation or, alternatively, through one (or more) discrete devaluations. These discrete devaluations could be announced as being strictly compensatory, and could be followed by a continuation of the crawling peg. An advantage of this type of scheme is that it would reduce (although possibly not completely eliminate) the negative interest rate impact of accelerated mini-devaluations. Additionally, the expected path of the equilibrium RER depreciation should be investigated. Finally, such a study should necessarily deal with the required accompanying fiscal and credit policies that would make the exchange rate policy effective. 2/

- 1/ A possible modification of the current policy would be, in the months to come to replace the practice of announcing the monthly devaluation in terms of cents by announcements in terms of a percentage devaluation. In this way the public would possibly become demystified with respect to the meaning of adjusting the exchange rate by a particular number.
- 2/ In considering the policy options available for the next few months it is important to be aware of what nominal exchange rate policy can and cannot achieve in terms of affecting the real exchange rate. Nominal devaluations cannot, on their own, affect the long-run value of the real exchange rate. Nominal devaluations can, however, help accommodate required changes in the equilibrium RER that stem from changes in RER "fundamentals," such as terms of trade and commercial policy. See my Exchange Rate Misalignment in Developing Countries (1988).

## 8. External Debt

The debt buy-back under the Brady Plan reduced the commercial bank debt by about US\$1.0 billion. The total external debt at the end of December 1990 (in millions of U.S. dollars) was:

Multilateral	1,179
Commercial Banks	632
Bilateral	1,322
Other	40
Total	3,173

The external debt is equal to 1.6 times exports of goods and non-factor services in 1990, a manageable level. The proportion of this debt with the multilateral development banks is fairly high (40 percent), which may limit Costa Rica's ability to borrow from those institutions.

### C. The 1991 IMF Agreement

On March 5, 1991 the GOCR submitted a letter to the IMF management requesting: (a) a stand-by arrangement in an amount of SDR 33.64 million, or 40 percent of quota (US\$49 million); (b) compensatory financing under the export shortfall and the oil import cost components of the compensatory and contingency financing facility (CCFF) in the amount of SDR 33.64 million (US\$49 million); and (c) external contingency financing to cover adverse developments related to oil import prices and coffee export prices in an amount up to a maximum of SDR 21 million (US\$30 million). Financing under the latter facility contains a symmetry clause, i.e., if prices are more favorable than envisaged in the program, purchases under the stand-by arrangement would be reduced and/or more net international reserves would have to be accumulated. The letter was accompanied by a Memorandum of Economic Policy which outlined the basic assumptions and policies of the economic program for 1991, and contained the quarterly performance targets.

The program includes five sets of quarterly targets, beginning March 31, 1991: (a) Central Government expenditures; (b) increase in net domestic financing of the non-financial public

sector (NFPS); (c) stock of net domestic assets of the Central Bank; (d) net international reserves of the Central Bank; and (e) stock of external payments arrears.

A brief discussion of each set of targets is presented below. The first quarter targets are indicative, i.e., the first formal targets are for the second semester. Detailed data on the targets are given in Table 4, IMF Stand-By Program.

1. Limits for Cumulative Changes in Central Government Expenditures

The rapid growth of Central Government expenditures in 1989 (31 percent, compared to an average inflation of only 16.5 percent) was the main cause of the fiscal crisis. In 1990 expenditures grew by 20 percent. The 1991 program limited government spending to 116,400 million colones, an increase of about 18 percent over 1990.

Performance has been as follows (in million colones):

	<u>Program</u> <u>Targets</u>	<u>Actual</u> <u>Performance</u> Million Colones	<u>Margin (+)</u> <u>or excess (-)</u>
Quarter I	26,000	25,854	+146
Quarter II	52,000	53,806	-1,806
Quarter III	81,000	88,440	-7,440
Quarter IV	116,400	N.A.	N.A.

The second quarter target was missed by 1,806 million colones and the third quarter target was missed by 7,440 million colones. It will be nearly impossible to meet the fourth quarter target.

2. Limits for Cumulative Change in the Net Domestic Financing of the Non-Financial Public Sector

The program limits the net domestic financing of the Non-Financial Public Sector (NFPS). The limit includes financing from the banking system and from the non-bank public, and changes in the floating debt ("giros por pagar"). The reduction in the stock of domestic debt (12,900 million colones or 2.1 percent of the GDP) would be accompanied by an increase in foreign debt of about 5,100 million colones (0.8 percent of the GDP). Therefore, the surplus of the NFPS would be 1.3

TABLE 4

# IMF STAND-BY PROGRAM

## Targets and Performance

	1990 Dec.31	Mar.27	1991 Jun.28	Sep.31	Dec.31
<b>I. Net International Reserves (NIR)</b>	-307.4	-124.1	-33.4	108.0	n.a
(In millions of U.S. Dollars)					
Net Official Reserves (NOR)	-32.4	2.7	59.5	168	n.a
Payment arrears	-275.0	-126.8	-92.9	-60.0	n.a
Commercial payments	123.1	45.1	0.0	0.0	n.a
External debt	151.9	81.7	92.9	60.0	n.a
Limit	...	-135.9	-12.6	-52.0	-28.4
Excess(-) or margin	...	11.8	-20.8	160.0	n.a
<b>II. External Payments Arrears and Comm.</b>	275.0	126.8	92.9	60.0	n.a
(In millions of U.S. Dollars)					
Limit	...	111.1	67.6	61.5	60.3
Excess(-) or margin	...	-15.7	-25.3	1.5	n.a
<b>III. BCCR: Net Domestic Assets</b>					
(In millions of Colones)	69240	43181	32122	17707	n.a
Net Int. Reserves	-35351	-14272	-3841	12420	n.a
Currency issue	33889	28909	28281	30127	n.a
Limit	...	51000	38195	44078	36384
Excess(-) or margin	...	7820	6073	26371	n.a
<b>IV. Credit to Nonfinanc. Public Sector</b>	93834	91506	91649	87474	n.a
<b>A. BCCR</b>	61948	57144	57409	54704	n.a
Central Government	28042	25844	26115	26418	n.a
Rest of pub sect	33906	31300	31294	28286	n.a
<b>B. Commercial Banks</b>	7427	7007	4352	-391	n.a
Central Government	19003	20336	19483	16393	n.a
Rest of pub sect	-11576	-13329	-15131	-16784	n.a
<b>C. Net dom. bond (private sector)</b>	24459	27355	29888	33161	n.a
Fiscal bonds	23999	26901	29082	32355	n.a
CODESA + ICE	460	454	806	806	n.a
<b>D. Floating debt</b>					
(Central Government)	...				
Change from 31/12/90	...	-2328	-2185	-6360	n.a
Limit change		-4300	-14000	-12900	-12900
Excess(-) or margin		-1972	-11815	-6540	n.a

SOURCE: Daily cable, weekly and monthly "Monetary Accounts" of Central Bank.

TABLE 4 (Cont'd)

# IMF STAND-BY PROGRAM

## Targets and Performance

	1990 Dec.31	Mar.27	Jun.28	Sep 30	Dec 31
V. Central Government: Cumulat. (In millions of colones)	99143	25854	53806	88440	n.a
Budgetary expenditures	83313	19883	43257	72912	n.a
Pending commitments	4364	3227	5329	6743	n.a
Extrabudgetary expenditure	11466	2744	5220	8785	n.a
Limit	--	26000	52000	81000	116400
Excess(-) or margin	--	146	-1806	-7440	n.a

SOURCE: Central Government.

percent of the GDP. With Central Bank losses of 1.8 percent of the GDP, the public sector deficit target was 0.5 percent of the GDP.

Performance has been as follows: (in million colones)

	Program Limits	Actual Performance	Margin (+) or excess (-)
<u>Cumulative Change from December 31, 1990</u>			
Through end March 1991	-4,300	-2,328	- 1,972
Through end June 1991	-14,000	-2,185	-11,815
Through end September 1991	-12,900	-6,330	- 6,540
Through end December 1991	-12,900	N.A.	N.A.

The limits for the first three quarters of 1991 were missed, and it is certain that the original December target will also be missed. The IMF, however, has agreed to modify this target.

### 3. Ceilings on the Stock of Net Domestic Assets of the Central Bank

The marked increase of net international reserves (NIRs) as part of the program (discussed below) would require a sharp decline in the net domestic assets of the Central Bank. The ceiling on net domestic assets assumes a sharp decline in bank credit to the public sector, consistent with the improvement in the fiscal situation and the assumption that domestic financing of the Central Government will depend almost exclusively on the placement of bonds with the non-bank public. The reduction in banking credit to the public sector would allow for an increase in credit to the private sector of 17 percent in 1991.

The ceilings are (in millions of colones):

<u>Periods</u>	<u>Stock Outstanding</u>	<u>Actual Performance</u>	<u>Margin (+) or excess (-)</u>
December 31, 1990	68,953	68,953	0
January 1 - March 31, 1991	51,000	43,181	7,820
April 1 - June 30, 1991	38,195	32,122	6,073
July 1 - September 30, 1991	44,078	17,707	26,371
October 1 - December 31, 1991	36,384	N.A.	N.A.

The limits were met by a significant margin in the first three quarters of the year.

4. Targets for the Stock of Net International Reserves of the Central Bank

The program calls for an increase in net international reserves (NIRs) of US\$333 million, consisting of an increase of net official reserves (NORs) of US\$120 million and a reduction of arrears of US\$213 million.

The targets are (in US\$ million):

<u>Periods</u>	<u>Stock Outstanding</u>	<u>Actual Performance</u>	<u>Margin (+) or Excess (-)</u>
December 31, 1990	-307.4	-307.4	0
January 1 - March 31, 1991	-135.9	-124.1	11.8
April 1 - June 30, 1991	-12.6	-33.4	-20.8
July 1 - September 30, 1991	-52.0	-108.0	160.0
October 1 - December 31, 1991	28.4	N.A.	N.A.

The first quarter target was met, the second quarter target was not met, partly because SAL II disbursement did not take place before the end of the quarter, and the third quarter target was met amply, with a margin of \$160 million. It is almost certain that the December target will be met amply.

5. Limits on the Stock of External Payment Arrears

The Program required a reduction of the stock of payments arrears of US\$213 million. While the reduction of arrears to foreign creditors was to be achieved largely through reschedulings, the Program required a reduction of the stock of foreign exchange requests at the Central Bank in excess of 15 days (the "presa"), which would, of course, require the use of liquid reserves.

The limits on external payment arrears are (in US\$ million):

<u>Periods</u>	<u>Stock</u>		<u>Performance or Excess (-)</u>
	<u>Outstanding</u>		
December 31, 1990	272.9	275.0	0
January 1 - March 31, 1991	111.1	126.8	-15.7
April 1 - June 30, 1991	67.6	92.9	-25.3
July 1 - September 30, 1991	61.5	60.0	1.5
October 1 - December 31, 1991	60.3	N.A.	N.A.

The first and second quarter targets were not met for technical reasons, while the third quarter target was met with a margin of \$1.5 million. It is not possible to predict whether the last quarter target will be met. If the authorities believe that international financial support, principally from the IMF and the World Bank, will be reduced, they may choose to accumulate arrears in order to strengthen the reserve position. This would, of course, be a major setback which would erode Costa Rica's credit worthiness.

D. Progress under SAL II and Plans for SAL III and Agricultural Sector Loan

The GOCR met all conditions, roughly on schedule in 1989, for the first disbursement of the SAL II, including the lowering of tariff barriers and management improvements in the state-owned banks. The second disbursement was delayed for lack of compliance in three areas. First, the fiscal situation deteriorated in 1989 and the Arias Administration was unable to reach the target for public sector savings (the savings target was 6 percent, while the actual savings were 3.5 percent). Second, the Arias Administration had failed to modify the system of export subsidies to satisfy the World Bank. Third, changes to permit private grain importers to import on equal footing with the CNP were not implemented. This latter measure was subsequently met by the Calderon Administration as a result of specific Conditionality contained in the FY90 P.L. 480 Agreement and the Assembly modified the export subsidy regime in a manner acceptable to the Bank. The last remaining obstacle to the second disbursement centered on the poor fiscal performance prior to the elections. In July 1991, after consultations with the IMF, the World Bank released the second tranche of SAL II (approximately US\$70 million).

The third tranche (\$50 million) has not been disbursed as of early December 1991. We understand that one reason for the delay has been the passage of an agricultural debt restructuring law

which goes against the tenets of the SAL II in a general sense. Additionally, the Bank is concerned with the recent events surrounding the resignation of the Minister of Finance. As a result the Bank has taken a wait and see attitude in order to assess the direction and commitment of the GOOCR to the adjustment process in the aftermath of the Minister's resignation. It now appears that the Bank will go forward with the third disbursement during the first quarter of CY1992 based on, among others, the apparent success of the GOOCR's voluntary labor mobility effort and their continued commitment to maintain fiscal discipline as well as meet their commitments to the IMF and the Paris Club.

Negotiations on the SAL III are proceeding but the original target for completion in March 1992 has now slipped. We estimate that the SAL III negotiation will not be completed until late 1992 or early 1993. In this context the FY1992 T&I Program will play an important catalytic role in advancing the adjustment process in that our conditionality fully anticipates the major components presently expected to be included under the SAL III Program. SAL III is expected to include conditions in three areas:

1. Public sector efficiency, including improvements in the social security system, improved budgeting, and reduction of the public sector labor force;
2. Trade liberalization, with emphasis on lowering effective protection significantly.
3. Financial sector reform, including an increased role for private financial intermediaries, improved banking supervision, and measures to increase the efficiency of state-owned banks.

In October 1991 the GOOCR and the World Bank concluded a year long appraisal and negotiation of a \$41 million Agricultural Sector Loan. The Mission worked closely with the Bank in this appraisal and provided the technical assistance and financing that was pivotal in assisting the Bank in defining and negotiating a range of important agricultural sector policy and institutional reforms. Among the more important measures agreed to are the following:

- the GOOCR would transfer 157 state retail food stores run by the Consejo Nacional de Produccion (CNP) to the private sector. With technical assistance and financing from A.I.D. all 157 stores were privatized through four regional cooperatives and more than 750 CNP employees

were released from the government payroll. This privatization has been successful and has received constant coverage in the national media. This single successful program, which daily reaches thousands of low income consumers, has had a major positive impact on the public's understanding and perception of the otherwise abstract concept of privatization.

- the CNP will lease or liquidate 50% of the grain storage and processing facilities which are presently closed;
- the GOCR will eliminate any quota restrictions to imports and exports of basic grains and beans;
- the GOCR will establish a tariff system to be applied to the CIF price of basic grains and beans and these tariffs will not exceed a ceiling of 20%;
- the GOCR will eliminate all price controls applied to basic grains and beans;

These measures, as a condition for the loan to be presented to the Bank Board, require that the GOCR issue an executive decree which will come into force no later than 30 June 1992.

### III. EVALUATION OF PERFORMANCE UNDER TRADE AND INVESTMENT I.

The FY 1991 ESF Trade and Investment Program I (TIP I), included 13 substantive conditions precedent which are shown in Annex B (Trade and Investment I Agreement).

Performance was as follows:

A. As noted in Section II.Q. (Performance Under the IMF Agreement), Costa Rica met three of the five IMF targets as of the end of September 1991. While the two fiscal targets were not met, the net international reserves target (the main objective of the program) was amply met. Therefore, as of October 5, we concluded that the GOCR had complied substantially with the goals of the macroeconomic stabilization program. The IMF has praised the AID role in maintaining pressure on the GOCR to comply with the program and in providing the resources and helping shape the mechanism to implement the downsizing of the public sector.

B. On June 27, 1991, AID received evidence from the General Secretary of the Central Bank that the Board of Directors approved a series of measures to enhance the independence of the Central Bank on June 26, 1991. These included: i) commitment not to subsidize exchange rate operations; ii) commitment not to assume the foreign exchange risk of third parties; iii) commitment not to finance the public sector, either directly or indirectly, except through "Letras del Tesoro;" and iv) commitment not to participate in international compensation schemes that would result in net credit to other countries.

C. On May 14, 1991, AID received a letter from the Second Vice-President and on June 25, 1991, a letter from the Ministry of Trade which included a plan to liberalize foreign trade through a schedule for tariff changes that would reach a maximum tariff of 20 percent as a general rule and a minimum tariff of 5 percent to 10 percent by 1992; as well as a maximum tariff of 20 percent for all products by 1994. This was the first GOCR formal commitment to lower the tariff ceiling. (Note: The original commitment was to lower the tariff ceiling to 20 percent by the end of 1992, with some exceptions. The struggle to be included within the exceptions threatened to delay tariff reduction. Therefore, the authorities have taken the decision to lower the tariff ceiling, for all products, to 20 percent by mid-1993. We believe that this is a sensible approach.)

D. On February 4, 1991, AID received evidence through Executive Decree No. 20208-P of January 21, 1991, that the negotiations with the World Bank for a SAL III had begun. While discussions between the World Bank and the GOCR on a SAL III are continuing, negotiations have not progressed as rapidly as had been expected.

E. On June 26, 1991, AID received a copy of a letter from the Ministry of Finance to the Second Vice-President as evidence that a study has been initiated to rationalize exonerations which will lead to a scheduled phasedown implementation plan. Legislation on exonerations has been submitted to the Legislative Assembly, and it is expected that it will be enacted in early 1992. Rationalization of exonerations will increase the neutrality of the system, reduce effective protection, and will be the most significant revenue measure of the 1992 fiscal adjustment program.

F. On June 17, 1991, AID received from the U.S. Embassy a memorandum confirming that negotiations between Costa Rica and the United States Government for a Bilateral Investment Treaty had been initiated. These negotiations have been proceeding on schedule.

G. On June 5, 1991, AID received a copy of a request from the Ministry of Finance to the IDB to perform an analysis of the investment climate. Preparation work for this operation has begun, and it is expected that it will be submitted to the IDB Board of Directors in 1992.

H. AID has received evidence from the GOCR through November 1991, that there was a reduction of 5,069 public employees and that the target of 7,000 positions will be reached by the end of 1991.

I. On June 26, 1991, AID received a copy of a letter to the Second Vice-President from the Ministry of Economy, Industry and Commerce as evidence of the submission of a bill to the Legislative Assembly that will allow the sale of 100 percent of CODESA's remaining subsidiaries to the private sector. Furthermore, program documentation of August 14, 1991, indicated that major reductions in the size and activities of CODESA had been carried out, that all future-oriented activities had been stopped, and that CODESA's principal offices were closed on September 16, 1991. While this is somewhat later than we had originally requested, the fact remains that the physical closing of CODESA has now taken place. Legal restrictions require that a minimum administrative staff be maintained and that this staff be housed in temporary quarters until what remains of CODESA can be legally dissolved.

J. AID has received evidence of the submission to the Legislative Assembly of Bills Nos. 11168 (Ley Marco) and 11177 (Teacher's Pensions) published in La Gaceta of March 11, 1991, and of April 18, 1991, respectively, that regulate public sector pensions. The Teacher's pension law was passed on November 11, 1991, representing the first time that any modification has been legally approved by the legislature for a pension fund. The Ley Marco is now in first debate in the Legislature and proposes that, of the 21 pension systems, 14 are to disappear. While

changes in this legislation are still possible, the fact that this bill has progressed to this point is a notable accomplishment.

K. AID has received evidence of the submission to the Legislative Assembly of the Legislative Bill No. 11187 published in La Gaceta of May 22, 1991, on a complementary pension system to be managed by private sector financial institutions. The Bill is due to enter the first of three required Assembly debates in the Extraordinary Session January 15, 1992.

L. On June 26, 1991, AID received a copy of a letter to the Second Vice President from the Minister of Labor as evidence which includes an action plan to improve the control and administration of the special pension systems of the public sector and control the complementary pension system of the private sector. To enhance its implementation, the plan will soon undergo reformulation to incorporate a phased approach for the proposed adjustments. Presently, a draft bill is before the legislature although will probably not enter into debate until March of 1992.

M. AID has received evidence of the submission to the Legislative Assembly of Legislative Bill No. 11019 published in La Gaceta No. 184 of August 21, 1990, which regulates laudos (mandatory court-ordered resolutions to public sector labor conflicts, resulting in salary adjustment). In August 1991, the bill was approved in committee and moved to the list of bills for first debate. It was not included by the Executive Branch for debate in the extraordinary session of December 1991, due to the number of other essential projects to be debated in what is usually a short time period.

#### IV. MAJOR ECONOMIC ISSUES

##### A. Macroeconomic Stability

The literature on structural adjustment always concludes that trade liberalization cannot succeed without a stable macroeconomic environment. Although the public sector deficit was reduced sharply since the crisis of the early 1980's, there has been continuing financial instability resulting from recurring fiscal imbalances. These fiscal imbalances are in turn the result of a secular growth of certain items of expenditure, mainly wages and salaries, pensions, transfers to the universities, export subsidies, and interest on the domestic debt of the public sector. While the consolidated public sector deficit was reduced sharply in 1991, this was accomplished, to a large extent, through the increase in the sales tax and through sharp increases in the prices and rates charged by state-owned enterprises. Given the already high tax burden, further increases in taxes are not advisable, and therefore the only viable alternative is to implement measures designed to constrain public sector expenditures.

The lack of autonomy of the Central Bank and the existence of dominant state-owned banks have facilitated the monetization of the public sector deficit, with sharp reductions in reserves and rapid inflation. Additionally, Central Bank losses, though declining, still amounted to 2.0 percent of GDP in 1990 and are estimated at 1.7 percent of GDP in 1991 and 1.2 percent of the GDP in 1992. The combined effect of the non-financial public sector deficit and of Central Bank losses has been a level of inflation significantly higher than historic levels. (The effect of the deficits on inflation is now greater than during the mid-1980's as there has been a sharp increase in the income velocity of M1, which increased from 6.4 in 1985 to an estimated 10 in 1991. This increase in velocity is partly due to the development of highly liquid interest-paying financial instruments.) The relatively high level of inflation has a negative effect on private sector savings and investment, and therefore on economic growth.

##### B. Exchange Rate Regime

In 1991, the stock exchange in Costa Rica was allowed to begin trade in dollar-denominated certificates of deposit, thus legalizing a market for foreign exchange outside the Central Bank. Although a legal spot market for foreign exchange outside the Central Bank still does not exist, it is possible to buy a certificate of deposit with five days or more remaining to maturity. This represents a major liberalization of the foreign exchange market. While the informal spot market handles a large amount of transactions (as an average, foreign exchange for 30 percent of imports is purchased in the informal market), criminal penalties remain on the books for those trading in that market. The informal market is, however, tolerated by the authorities and no cases of criminal conviction are known in recent years.

Some uncertainty exists in the foreign exchange market because of a constitutional provision (Article 121, Clause 17 of the Constitution) which states that the Legislative Assembly must ratify the level of the exchange rate. The level ratified by the Legislative Assembly is 20 colones per US\$ while the actual exchange rate exceeds 135 colones per US\$. This matter has been taken to the Constitutional Court (Sala IV). Obviously, if the Sala IV were to decide that the exchange rate is actually 20 colones per US dollar, economic chaos would ensue. Regardless of the Sala IV decision, it is necessary to establish a legal basis for the foreign exchange regime which recognizes the current practice, i.e., the exchange rate is established by the Central Bank.

The establishment of a legal market for dollar-denominated certificates of deposit has resulted in a major liberalization of the capital account of the balance of payments, as it is possible to purchase a certificate of deposit and remit the dollars abroad when the certificate of deposit becomes due. Permitting the purchase of dollars at the Central Bank without limit for remittances abroad could reduce transaction costs, and would encourage foreign investment. Additionally, contracts denominated in foreign currencies are not legal in Costa Rica. Permitting them could contribute to a reduction of uncertainty.

### C. Trade Liberalization

Costa Rica's medium and long-term growth prospects will continue to be restricted by a series of factors, including (1) its debt-service burden (even after the May 1990 commercial debt buyback and anticipated further rescheduling); (2) the loss for the foreseeable future of its access to capital from foreign commercial banks; (3) limits on potential official capital inflows; and (4) modest prospects for the growth of traditional exports. This means that the future of Costa Rica's economy will depend primarily on the country's ability to expand and diversify its non-traditional exports. This will require continued improvements in the climate for trade and investment.

Costa Rica began the process of trade liberalization in Central America in the mid 1980s, but now other countries are moving at a faster pace to reduce effective protection. To remain competitive in the region, Costa Rica will have to lower the maximum tariff rate, reduce tariff dispersion, and eliminate most exonerations for firms producing for the local market. Furthermore, a large proportion of imports does not pay duties. Although exonerations for exporters make economic sense, as they reduce the anti-export bias, exonerations for domestic producers increase effective protection and thus contribute to misallocation of resources.

Trade liberalization requires fast resource reallocation which can only be carried efficiently within a system of rapidly adjusting relative prices. Pervasive price controls which exist in Costa Rica would increase the short-run costs associated with trade liberalization.

#### D. Financial Sector

In the mid and late 1980 Costa Rica undertook a series of measures designed to liberalize the financial sector, but there is a need to further deepen this process. For example, while interest rates were allowed to rise, the Central Bank continues to have the power to establish interest rates. (Eliminating this power of the Central Bank requires modification of at least two articles of the Central Bank Law - Article 64(2) and Article 85(1-a.) Also, while greater use is being made of orthodox instruments of monetary control, the Central Bank still has the power to establish credit ceilings ("topes de cartera"). (Eliminating this power of the Central Bank would require modification of Article 86 of the Central Bank Law.)

Reserve requirements for deposits of more than 180 days are established by legislation at a maximum of 10 percent, and the Inter-American Bank investment climate appraisal mission has recommended that the maximum be lowered to five percent. Reserve requirements for deposits of shorter maturity can be changed by the Central Bank up to 50 percent, but this upper limit is still considered to be too high. This power should be curtailed, thus forcing the Central Bank to exercise monetary control mostly with actions which affect the monetary base, i.e., open market operations.

The banking system is highly inefficient. In 1989, for example, administrative costs in the state-owned banks were equal to 12.5 percent of total deposits, a level at least twice as high as most developing countries. It is very difficult, however, to increase the efficiency of the banking system because the state-owned banks have a predominant position in the financial system, accounting for 85 percent of all assets and 70 percent of all loans of the system.

Privatizing state-owned banks for the foreseeable future is probably impossible because of political reasons, but measures must be taken to increase their operational efficiency. Establishing objective criteria that would limit costs (administrative costs and costs associated with bad loans) could increase efficiency, but the mechanism to achieve this would require in-depth analysis.

Private banks are at a disadvantage with respect to state-owned banks. Measures that would enhance their competitiveness are:

1. Private banks should be given access to the rediscount window at the Central Bank to meet short-term liquidity problems. (Article 62-1 of the Central Bank Law would have to be modified.) This would permit private banks to increase their interest earning assets. Alternatively, a special fund (lender of last resort) for private banks could be established using external resources and HCOLC.

2. At present private banks cannot issue certificates of deposit of less than 90 days, nor can they issue demand deposits, and therefore their cost of funds is higher than for the state-owned banks. (Permitting private banks to issue the same investments as state-owned banks would require changes in Article 1 of the Banking Nationalization Law, Article 59 of the National Banking System Law, and Article 13-d of the Non-Banking Finance Companies Law.)

3. Prudential supervision is presently not sufficient to guarantee the soundness of the financial system. An AID financed project (Financial Services Project) is assisting the bank supervisory agency to improve prudential supervision, particularly of credit unions.

#### E. Public Sector Efficiency

In 1950, the public sector labor force was 6 percent of the total workforce, it increased to 20 percent in 1987, and declined to 17 percent in 1990. The public sector increased its participation in the economy rapidly until the crisis of the early 1980's. While sharp reductions in the deficit took place since the crisis of the early 1980's, this reduction resulted, to a large extent from decreases in public sector investment.

In 1990, when the Calderon administration took office, the deficit was increasing rapidly, and would have reached 7 percent of the GDP if corrective measures had not been taken. Given the urgent nature of the fiscal adjustment, reliance was placed predominantly on revenue enhancement measures. The most important challenge faced by Costa Rica is the need to attain fiscal balance, but the tax burden is relatively high, and a large proportion of revenue is accounted by payroll taxes. Therefore, the ability to restore fiscal balance will depend on measures which constrain the growth of current expenditures, mainly wages, transfers to universities, pensions, export subsidies, and interest on the domestic debt. Controlling interest on the debt would require macroeconomic stability (so that interest rates decline), a reduction of domestic finance of the deficit, and a reduction of the stock of debt through the sale of state-owned assets, i.e., privatization.

In a number of areas of the public sector, principally health, housing, agriculture and transportation, there exists duplication of functions in different agencies, as well as massive redundant personnel. Restructuring these sectors is necessary to increase the efficiency of the public sector. Studies which will serve as the basis for doing this restructuring are currently being carried out by the local HCOLC financed Foundation for Cooperation with the State (Spanish acronym - FUCE).

In general, services which could be contracted to the private sector are carried out directly by public sector institutions in a highly inefficient manner. The private provision of these services could markedly increase efficiency.

One of the main constraints to export-led growth is the inefficient ports which are, with the exception of the sugar port, owned and operated by the public sector. Present port capacity is not sufficient to handle even the exports that would result from recent increases of the banana plantations in the Atlantic Coast. Therefore, trade liberalization will fail unless actions are taken to facilitate private sector involvement in the finance of new port facilities and in the management of existing facilities. A recent study financed by a local institution concludes that legally, establishment of a private port is possible, but only after compliance with what appear to be arduous regulations.

## V. PROGRAM RATIONALE

The 1991 ESF Program (Trade and Investment I) supported a number of policy initiatives to promote macroeconomic stabilization, trade liberalization, improvements in the investment climate, and increases in the efficiency of the public sector. These measures were fully supportive of the IMF Stand-by Agreement, and of a planned Third Structural Adjustment Loan (SAL III) from the World Bank and a planned Investment Sector Loan (ISL) from the Inter-American Development Bank (IDB). The measures undertaken under the TIP I are detailed in Section III of this Concept Paper and prepared the way for the proposed loans from the World Bank and the IDB. The basic assumption was that the SAL II and the ISL would be negotiated early in 1992, and that the policy measures initiated by the TIP I would be implemented through legislative and/or administrative actions that would result from the agreements with the World Bank and the IDB.

The IDB Investment Sector Loan (which is being formulated with the support of the AID-financed Financial Services Project) is proceeding as planned, but there are two potential problems which could delay this operation. The first possible delay may result from an item in the policy agenda which would give private banks access to a rediscount facility at the Central Bank which would serve as the lender of last resort for banks facing temporary liquidity problems. There is stiff opposition to this measure from the Partido Liberacion Nacional (PLN) on largely ideological grounds. An option being considered by the authorities is to establish the facility using foreign resources and reflows from fully monetized HCOLC private sector loan lines. (Private banks already are permitted to borrow foreign funds under present legislation up to 50 percent of their total loans outstanding.) A second delay may arise because of the initial IDB requirement that private banks be allowed to issue certificates of deposit of any maturity. Although private banks have developed highly liquid instruments that are the equivalent of very short-term certificates of deposit, permitting the private banks to issue certificates of any maturity would reduce transaction costs and could reduce investor uncertainty. Giving greater flexibility to private banks is being opposed by the PLN.

The probability that a SAL III can be negotiated before the end of 1992 is low. The main reason for this is that the SAL III agenda includes a set of conditions designed to reform the public sector, and it may be difficult to implement them at this time for the following two reasons: First, the measures would result in a reduced role for the state, and it is not clear that the administration is prepared to pay the political price, in the final analysis, to pursue this vigorously. Even if it is, it is not clear that the necessary bipartisan political support

could be obtained. Second, the reforms require a level of administrative and implementation capacity that may not be available. While AID is financing technical assistance to support the reform of the state, this is probably not sufficient.

In view of the uncertainty regarding the timing of the SAL III and the ISL, the Trade and Investment Program II has been designed to set the stage for and start the process of accomplishing some of the most important policy changes of those two loans. These changes, however, cannot be accomplished in a single year, and therefore the USAID Mission has developed a two year ESF Program that will have more credible prospects for significantly affecting trade liberalization and improving the investment climate. The ESF Program is meant to reinforce and accelerate the IMF, World Bank and IDB programs.

From a purely tactical standpoint, a two-year program provides the Mission with more leverage with respect to the policy reform which will be sought, than it might have with a one-year program involving a relatively lesser amount of dollars. Conditionality discussions have begun, based on the clearly stated premise that the GOCR must vigorously pursue policy reform for the next two years if disbursements are to be made. This will also provide us with some certainty of a continuum to the policy reform, i.e., that a coherent and forceful agenda is pursued by the GOCR throughout the life of the program and that we can maintain a place at the negotiating table, emphasizing to the government the importance of compliance with conditionality that will pave the way for fruitful discussions with the multilateral donors. Politically, it is perhaps more important to conclude negotiations with the GOCR on a policy agenda at a time when they are still amenable to making changes in the public sector, the financial sector and the trade and investment area. As the late 1993 campaign season approaches, the GOCR's enthusiasm for policy reform and the discussion surrounding it could conceivably wane.

On a more mundane level, it is important for the Mission to establish the groundwork for an economic stabilization program for the next two years, simply due to the reduced staffing prospects which it faces. This will necessarily increase the workload of the remaining staff, responsible for a portfolio which includes 28 projects, two of which are major regional efforts which require considerable oversight (EARTH and Regional Administration of Justice).

Finally, it is logical that the Mission should attempt to enhance the influence and leverage we now have by presenting a two-year program to the GOCR. Throughout 1992 we will have the opportunity to fine tune the policy agenda, submitting to AID/W a detailed piece on policy compliance and, subject to our judgment at the time, suggesting further specificity or change to the conditionality agenda.

## VI. THE PROPOSED PROGRAM

### A. Economic Policy Measures

The Mission has discussed a two-year economic policy agenda with all key Costa Rican players, including the Second Vice-Presidency, the Ministry of the Presidency, the Ministries of Finance and Economy and the Central Bank. This agenda is summarized in the attached matrix (page 40a).

#### 1. Macroeconomic Environment

The first set of conditionality items (Section 1 of the Matrix) are measures designed to maintain a stable macroeconomic environment. The authorities are negotiating the extension of the IMF agreement until the end of 1992. The centerpiece of the program will be a reduction of the public sector deficit (including Central Bank losses) from 1.8 to 2.0 percent of the GDP in 1991 to not more than one percent of the GDP in 1992. We are in full agreement with this aspect of the program.

As detailed in Section III of the Concept Paper, the Central Bank Board of Directors approved a resolution that would tend to improve the financial position of the Central Bank. An AID-financed study made some additional recommendations, and many of them have been incorporated in a constitutional amendment which was drafted by two key legislators, one from each major political party, and which is presently being discussed in the Legislative Assembly. Although the fate of this amendment is difficult to predict, the Mission will continue to pursue ways to increase Central Bank independence.

#### 2. Exchange Rate Regime

The exchange rate regime has been liberalized de facto, particularly in 1991 when the market for dollar denominated CDs was established in the stock exchange. Further liberalization of the capital account of the balance of payments, and the legalization of dollar denominated contracts can contribute to greater certainty for investors, and would make the negotiation for a Bilateral Investment Treaty with the US easier. Reducing present uncertainty with respect to the mechanism to modify the exchange rate can also contribute to investor confidence.

A bill that incorporates many of the recommendations of an AID-financed study on this subject is being discussed by a bipartisan commission of legislators, economists and lawyers. If passed, this bill would considerably liberalize the exchange rate regime.

# POLICY MATRIX

GOAL/OBJECTIVE

MEASURES FY 1992

MEASURES FY 1993

STAFF WORK/  
ANALYSIS REQUIRED

## 1. Macroeconomic Stability

Maintain adequate macroeconomic environment

\* Fiscal, monetary and balance of payments targets met

\* Fiscal, monetary and balance of payments targets met

\* BCCR/IMF economic program to be formulated

Increase independence of the Central Bank

\* Prepare plans to improve balance sheet and financial administration of the BCCR

\* Implement plans to improve balance sheet and financial administration but long term plan is needed

\* Draft modification of "Ley Organica del Banco Central" along the lines proposed by de la Cuadra

\* Sergio de la Cuadra has prepared analysis of the BCCR

\* Sergio de la Cuadra has prepared report.

## 2. Deepen

Liberalization

Exchange Rate

Regime

Reduce uncertainty among foreign investors and among exporters and importers

\* Draft legislation to permit Central Bank to establish exchange rate

\* Sergio de la Cuadra has prepared analysis. Coordinate with commission named by GOCR

\* Draft legislation to free capital account of the balance of payments

\* Needs further analysis. S. Edwards could carry out analysis

\* Draft legislation to permit contracts denominated in foreign exchange

\* Does not require further analysis

GOAL/OBJECTIVE

MEASURES FY 1992

MEASURES FY 1993

STAFF WORK/  
ANALYSIS REQUIRED

3. Deepen Trade Liberalization

Reduce effective protection

\* Approve schedule of tariff reduction to establish maximum tariff of 20% and minimum tariff of 5-10% by June 1993 with a minimum of exceptions

\* Do not deviate from schedule

\* Does not require further analysis

Increase efficiency of resource allocation

\* Draft legislation to eliminate domestic price controls and profit margins except for a reduced number of commodities (less than 15, for example)

\* Submit bill to Legislative Assembly

\* AID is financing study

Protect intellectual property rights

\* Submit to the Legislative Assembly bill to increase protection for intellectual property rights

\* Pass legislation to increase protection for intellectual property rights

\* Embassy has given model legislation to GOCR

GOAL/OBJECTIVE

MEASURES FY 1992

MEASURES FY 1993

STAFF WORK/  
ANALYSIS REQUIRED

4. Increase Efficiency  
of Financial Sector

Liberalize the financial sector, reduce intermediation costs and increase financial savings

- \* Draft legislation to eliminate the power of the BCCR to establish interest rates
- \* Draft legislation to eliminate the power of BCCR to establish credit ceilings
- \* Study tax laws which affect the capital market and propose improved legislation

- \* Submit bill to Legislative Assembly

\* Sergio de la Cuadra has prepared analysis

- \* Submit bill to Legislative Assembly

\* Sergio de la Cuadra has prepared analysis

\* Requires study by Financial Services Project

Reduce operating costs of state-owned banks

- \* Formulate strategy to increase the efficiency of state-owned banks.

\* Financial Services Project can formulate strategy

- \* Limit subsidized credit and reschedulings

- \* Limit subsidized credit and reschedulings

\* Criteria can be established by Financial Services Project

GOAL/OBJECTIVE	MEASURES FY 1992	MEASURES FY 1993	STAFF WORK/ ANALYSIS REQUIRED
5. <u>Increase Efficiency of the Public Sector</u>			
Reduce expenditures	<ul style="list-style-type: none"> <li>* Provide evidence that public employment was reduced by 7,000 in 1991 and provide schedule of additional reductions of 7,000 in 1992</li> <li>* Prepare plans to restructure health, housing, agriculture, and transportation sectors</li> <li>* Carry out studies to identify public services which can be provided more efficiently by the private sector</li> <li>* Promote project to permit the private sector to manage port facilities (design, build and manage)</li> </ul>	<ul style="list-style-type: none"> <li>* Provide evidence that public employment was reduced by 7,000 in 1992 and provide schedule of additional reductions of 7,000 in 1993</li> <li>* Implement recommendations of plan, submitting to the Legislative Assembly the necessary legislation</li> <li>* Submit legislation and/or modify regulations to implement recommendation of studies</li> </ul>	<ul style="list-style-type: none"> <li>* FINTRA contracts with local experts for analysis of GOCR function</li> <li>* FINTRA contracts with local experts for analysis of function in these ministries</li> <li>* Terms of reference of studies need to be prepared</li> </ul>

### 3. Trade Liberalization

The process of trade liberalization has been at a standstill in Costa Rica after the lowering of the maximum tariff rate to 40 percent. The policy dialogue of the Mission since 1990 has been concentrated in this area and in July 1991, at an AID financed seminar on trade liberalization, President Calderon announced that further tariff reductions would take place. In November, in a major speech, President Calderon reiterated that the tariff ceiling for most products will be lowered to 20 percent by the end of 1992 (with up to a maximum of nine exemptions), and that it will be lowered to 20 percent for all goods by the end of 1993. The determination of the list of exemptions has generated debate and has threatened the trade liberalization process. Therefore, the decision was taken to reduce tariffs for all products, beginning in early 1991 and on equal installments, to reach a tariff ceiling of 20 percent by June 1993, without exceptions. This is almost the precise language contained in the Mission's conditionality for TIP I of FY 91. The implementation of this reduction is a main item of conditionality of the TIP II.

The reduction of price controls was discussed during the negotiations for TIP I, and the GOCR made an informal commitment to study this issue. An AID-financed consultant has been working on a plan to significantly reduce price controls. Implementation of that plan will be another important step towards a more liberal economy.

The USG is negotiating the passage of legislation to give greater protection to intellectual property rights, thus accelerating negotiations for a Free Trade Agreement with the US. Presenting this legislation to the Legislature, and its passage are conditions for the 1992 and 1993 ESF Agreement, respectively.

### 4. Financial Sector

The Central Bank does not set interest rates and does not establish credit ceilings as it used to do in the past, but it continues to have the power to do so. Eliminating that right, in order to avoid any reversal of present policies, was recommended by an AID-financed study. Drafting legislation in this area and submitting it to the Legislative Assembly will be conditions of the 1992 and 1993 ESF Agreements.

The tax laws discriminate against equity financing and in favor of debt financing, and do not adjust revenue and expenditures to fully account for the effects of inflation. The preparation of a study that will expand an initial study financed by AID will be a condition of the 1992 Program.

The four state-owned banks have high operating costs. While the logical step would be to privatize at least three of the four banks, this is not considered politically feasible at this time. A study recommending measures to increase their efficiency will be a condition of the 1992 ESF Program.

Maintaining the present stock of subsidized credit at the present level (in nominal terms) and the avoidance of additional subsidized debt restructuring will be conditions of the 1992 and 1993 ESF Programs.

#### 5. Public Sector

Further employment reductions of 7,000 workers per year from the public sector will be conditions of the 1992 and 1993 ESF Programs, as the GOCR continues its restructuring of the public sector to achieve greater cost and operational efficiencies.

The preparation of a plan to restructure the health, housing, transportation and agriculture public sub-sectors will be a condition of the 1992 ESF Program, and the passage of legislation to implement those recommendations will be a part of the 1993 ESF Program.

A study to determine which public services can be provided more efficiently by the private sector will be a condition of the 1992 ESF Program, and the passage of the necessary legislation and/or regulations will be a condition of the 1993 ESF Program.

The ports are a major constraint to trade liberalization in Costa Rica, as the physical infrastructure is limited and the administration (by the public sector) is highly inefficient. It is not immediately clear whether changes in legislation are required to permit the private sector to invest and manage ports. A condition of the 1992 ESF Program will be that the necessary measures are undertaken to encourage private management of at least some of the ports of Costa Rica.

#### B. Timing of Disbursements

With a relatively low level of assistance, it does not make sense to have more than one tranche. Therefore, we would propose that the entire 1992 ESF be disbursed after the CPs of the first year are met, and that the entire 1993 ESF be disbursed after the second year CPs are met.

### C. Uses of Dollars and Local Currency

The cash transfer dollars will be directed to one of two alternate uses, to be determined by the Mission. The first alternate is to reimburse the Central Bank of Costa Rica (Spanish acronym - BCCR) for eligible private sector imports, and the second is to pay for debt service to international financial institutions (IFIs). The Mission will elect the first alternative if it wishes to generate host country owned local currency exclusively for the GOCCR labor mobility program. We have received assurances from the IMF that monetization associated with labor mobility payments will be excluded from their final monetization targets. If not, it will elect the second alternative which does not generate HCOLC. This approach follows the guidance received in the 1991 Action Plan review.

The March 8, 1991 memorandum from John E. Mullen, DGC, to Mr. Reginald J. Brown, AA/PPC, clarified that the dollar uses determine whether HCOLC is generated.

Regarding cash-disbursing assistance, where the agreement calls for the dollars to be sold at auction, the local currency that results has been generated. Where the dollars are placed in a separate account and used for private sector imports of goods or services, that too should result in 'generated' local currencies. On the other hand, when separate account dollars are used for foreign public debt repayment, government imports, or invisibles such as embassy expenses abroad, no local currency is likely to flow to the host government and therefore none is 'generated'.

According to the same memorandum, a Mission may, in the cash transfer agreement itself, require the recipient government to deposit HCOLC into a special account even in cases where the dollar uses do not, of themselves, result in HCOLC generations. However, USAID/Costa Rica has no intention of imposing such a requirement.

#### 1. Dollars

During the period 1982-1991, ESF resources administered by the Mission not only helped achieve U.S. regional political and economic stability objectives, but also played a decisive role in Costa Rica's own progress toward economic stabilization and recovery, enabling Costa Rica to meet more of the real import requirements of sustaining higher growth rates than would otherwise have been attainable. These funds were dispersed against appropriate benchmarks in the implementation of economic reform programs that were sufficiently credible to merit broad support from the International Monetary Fund (IMF) and World Bank, among others.

Over this period the Mission signed ten annual agreements with Costa Rica for a total of \$960 million, all of which has been disbursed except for ten million from ESR VIII. Disbursement of this sum is contingent on satisfactory resolution during FY 1992 of outstanding U.S. property expropriation cases. Overall during the ten year period, the U.S.-financed Economic Stabilization and Recovery (ESR) balance of payments loans and grants provided critical foreign exchange for the GOCR and Costa Rica's private productive sector.

Through past ESF programs, this U.S. assistance, in conjunction with that from other international donors, has supported major adjustment efforts involving macroeconomic and structural reforms essential to achieving sustainable long-term growth. Reforms included privatization of more than 45 separate GOCR entities; substantial liberalization of the financial system, including a unified market-based exchange rate regime; maintenance of positive real deposit and lending interest rates; substantial reduction in past public sector deficits; and passage of a monetary reform law which improved the competitive position of private banks in a State bank-dominated system.

Beginning with the FY 1991 Trade and Investment I Program (TIP I), conditionality has been and will continue to be focused for the remaining years of ESF availabilities principally on (1) improving the policy, regulatory and market conditions for export led growth based on a free trade and investment climate and (2) supporting efforts to restructure and downsize GOCR public sector operations toward making them more efficient and cost controllable. These two objectives are closely interlinked and mutually required for the overall goal of attaining sustainable long-term growth conditions.

## 2. Local Currency: Background and HCOLC Monetization Planning

Between 1982 and 1991 AID and the GOCR have signed ten ESR Agreements providing \$802 million in assistance, of which \$764 million have been disbursed for Balance of Payments and for Trade and Investment. The counterpart colon equivalent deposited in the Special Account at Banco Central (BCCR) is the total amount of C57,319 million. Colon deposit amounts reflect differing exchange rates in effect at the time of each year's deposits. The 57,319 million colon figure includes interest earned and paid by the BCCR to the Special Account and also an estimated C3,000 million associated with the FY 1991 ESF cash transfer of \$24 million. But it does not include \$10 million from ESR VIII disbursement which is tied to satisfactory resolution of outstanding U.S. investor disputes.

Over the last year the Mission conducted a thorough review of existing Local Currency AID/GOCR programming commitments and

plans associated with ESR grant activities for the next few years. Two factors strongly influenced this review: one, the expectation of a substantially reduced flow of dollars to underwrite monetization over the next few years, and two, the broader serious fiscal management challenges facing the country. While USAID and the GOCR remain committed to honoring existing agreements, there is also a need for agreement on parameters as to how this impacts on future years programming. In this respect the Mission has established the following guidelines:

First, there will be no generation of local currency for new programs for dollars grants from 1992 forward with the possible exception (agreed to with the IMF) of local currency to support the costs of permanently downsizing the public sector workforce (labor mobility). Second, monetization will support only existing AID/GOCR plans. Third, any monetization for AID activities or GOCR sector programs (with the exception of labor mobility) will not exceed the colon value of new ESR dollar grants. Fourth, by 1994 there will be a positive flow of dollars in the program.

However, it should be noted that monetization planning for 1992-1994 does not include the FUNDEX, FORESTA, EARTH or FINTRA activities, all of which operate under separate agreements for monetization with the BCCR.

#### D. Implementation Procedures

##### 1. Disbursement Procedures

###### a. Alternative 1

If USAID elects to reimburse the BCCR for eligible private sector imports, the following disbursement procedures will be used. Dollars will be disbursed by means of electronic funds transfer (EFT) effected by the U.S. Treasury to a separate account established for this purpose in the Federal Reserve Bank of New York (FRB/NY) which will assure that the sub-account established to receive these funds will preclude commingling of Cash Transfer dollar funds with other resources. The EFT from Treasury to FRB/NY takes virtually no time at all, and the funds do not pass through any intermediate banks.

The account will include and will be credited for any interest earned from funds held in this account and for GOCR refunds for unacceptable disbursements from the account, if any.

The separate account will be monitored closely by the Mission. The BCCR will be instructed to request the FRB/NY to advise

USAID of any movement in the account, including interest earned, by means of telex, fax or letter as the circumstances may dictate. Cable traffic between the FRB/NY and the BCCR will also be provided to USAID. Copies of the bank statements from the FRB/NY for the separate account are obtained directly from the FRB/NY at least once a month, as long as the cash transfer agreement is not fully disbursed or there are funds remaining in the account. After each cash transfer has been fully released from the separate account, a copy of a statement for the separate account is requested from the FRB/NY. The statement following release of the final cash transfer amount will be checked to assure that there are no remaining funds in the account.

b. Alternative 2

If USAID elects to allow the GOCR to use the cash transfer to pay for debt service to IFIs, the disbursement procedures will be almost identical to those described in the preceding section. Dollars will be transferred from the U.S. Treasury to the separate account in the FRB/NY, as described above.

The GOCR will then direct FRB/NY to transfer cash from the separate account to the accounts of IFIs, most or all of which also have accounts at the FRB/NY, to meet Costa Rica's debt service payments when they come due to the IFIs. The BCCR will assure that the IFIs confirm to USAID the debt service payments received.

2. Reimbursement Procedures

a. Alternative 1

If USAID elects to reimburse the BCCR for eligible private sector imports, the following reimbursement procedures will be used. The following shall be considered eligible imports: raw materials, intermediate goods, spare parts, final goods, and capital goods shipped from, but not necessarily grown or manufactured, in the United States and imported after the effective date of the Agreement. Items from the following list are not, repeat not, eligible for reimbursement from the cash transfer dollar funds.

- PL-480 commodities
- Fine furs
- Explosives and ammunition
- Passenger cars
- Firearms/military equipment
- Gambling Equipment
- Police equipment
- Weather modification equipment

Alcoholic beverages  
Jewelry  
Surveillance equipment  
Pesticides  
Materials or equipment for commercial timber harvesting in primary forests  
Gold, silver, and coins/stamps  
Abortion equipment  
Non-durable consumer goods.

In order to obtain reimbursement for the payment from existing GOCCR foreign exchange reserves for eligible imports into Costa Rica, the BCCR presents the Mission with a listing of private sector import transactions to be reimbursed by the dollar funds whose release from the separate account is being requested.

A local public accounting firm reviews and confirms the eligibility of the listed transactions. After confirmation, the Mission 'releases' the funds from the separate account by providing to the BCCR written permission to withdraw the funds from the separate account. Prior to the release, the BCCR must indicate in which banks and in which accounts it wants to deposit the funds. The BCCR must have previously submitted a certification by the Bank Auditor General of Costa Rica, or other competent entity, that these accounts are recognized and legitimate GOCCR accounts.

Finally, the Mission requests that the BCCR instruct the banking institution(s) to which funds are to be released, to directly advise USAID of the account number, date and amount of the deposit(s).

#### b. Alternative 2

If USAID elects to allow the GOCCR to use the cash transfer to pay for debt service to IFIs, there is no reimbursement. Payments to the IFIs will be made as described in section VI.D.1.b., above.

### 3. Audit Provisions

#### a. Dollars

If the Mission determines that an audit of the cash transfer dollars is necessary, it will ask the AID Inspector General to perform the audit. Because of the simplicity of the proposed disbursement procedures, the security and reliability of the FRB/NY, and the routine receipt by the Mission of bank statements and other transaction documents, it is unlikely that the Mission will ask for an audit of the cash transfer dollars.

b. Local Currency

If HCOLC is generated, it will be used only for the GOCR's labor mobility program through procedures already established and implemented over the last year. The labor mobility employee severance payments are made by a non-governmental foundation called the Foundation for Cooperation with the State (FUCE). Under current procedures, FUCE receives a grant from the GOCR Ministry of Planning funded with cash transfer generated, host country-owned local currency (HCOLC). The Ministry of Planning receives the HCOLC pursuant to programming agreements with USAID which, pursuant to the programming agreements, transfer HCOLC from the USAID-controlled HCOLC special account at the BCCR to the Ministry of Planning-controlled special account at the BCCR.

The grant agreement between the Ministry of Planning and FUCE contains a requirement for annual recipient-contracted audits of the program. USAID monitors the performance of these audits and assures that it receives copies.

In addition, since FUCE has received previous grants for this same purpose from the Ministry of Planning, and since FUCE has already planned to contract an independent audit of that activity, USAID is taking steps to assure that the resultant audit report contains an assessment of FUCE's internal controls in accordance with U.S. government auditing standards. Presently, the Mission believes that an audit report of FUCE-managed labor mobility activities to date would meet the financial assessment requirements established in STATE 204855, "Supplemental Guidance on Programming and Managing HCOLC," for extra-budgetary support activities, and the recipient-contracted audits required by future agreements between FUCE and the Ministry of Planning are intended to meet the monitoring requirements of that same guidance.

c. Other

The last cash transfer agreement, ESR X, contained a covenant which required the GOCR to audit annually all dollar funded Development Assistance activities for which it was the implementing agent, and all ESF and PL 480-generated HCOLC activities. This covenant will be repeated again this year, but this time specific remedies will be defined for non-compliance, such as closing of activities and return of unspent HCOLC to be used for other purposes.

E. Relationship with Mission Strategy

The Mission's overall country strategy goal for the 1990s is to help Costa Rica reach independent and sustainable developed country status. The sub-goal seeks to assist the country to further deepen and expand its commitment to sound trade and investment policies. This strategic approach builds on the

substantial macroeconomic stability and growth gains made over the 1980s and reflects current expectations for U.S. assistance flows in the 1990s. It focuses on three carefully articulated Mission strategic objectives, the substance of which is shared by the GOCR, U.S. economic assistance managers and the other major donors, principally the IMF, the World Bank and the IDB.

These three objectives are (1) an improved business climate, (2) more cost efficient and responsive government operations, and (3) increased preservation and sustainable use of the natural resource base. The annual TIP programs for the next two or three years, as detailed in this Concept Paper, are structured in careful coordination with other donors and directly relate to the overall strategy for U.S. economic assistance.

#### F. Complementary Mission Activities

Residual conditionality from prior years' programs and local currency planning and uses both strongly support the core objectives of this proposed TIP II. Additionally, substantial resources from the Development Assistance (DA) side of the U.S. economic assistance package are also closely tied to and supportive of the overall objectives. The Policy Analysis and Training Support project (515-0241) is the principal funding source for the many studies, seminars, observation tours and short and long-term training that have been organized over recent years and are planned for the next few as well to support the three Mission strategic objectives. Mission PD&S funds also support these objectives, as do the Financial Services project (515-0247) and, perhaps less directly, funds for various Environmental and Natural Resources management activities.

#### G. Other Donor Coordination

The principal other donors involved in supporting Costa Rican efforts to achieve independent developed nation status in the 1990s are the International Monetary Fund (IMF), the World Bank and the Inter-American Development Bank (IDB). This Concept Paper is replete with references and cross linkages between planning for the use of U.S.-supplied ESF funds and the plans and resources of these organizations. This coordination and symmetry of plans is no coincidence. Consultations are frequent and substantive. It is worth noting as well that these linkages are well known to, understood by and fully accepted by the GOCR. Given the difficult political and resource tradeoff decisions Costa Rican leaders, public and private, must reach consensus on and carry out, no one can guarantee that this combined effort will succeed as planned and within the anticipated timeframe, but it can be said with confidence that the final objective is understood by all parties and that our respective planning reflects it.